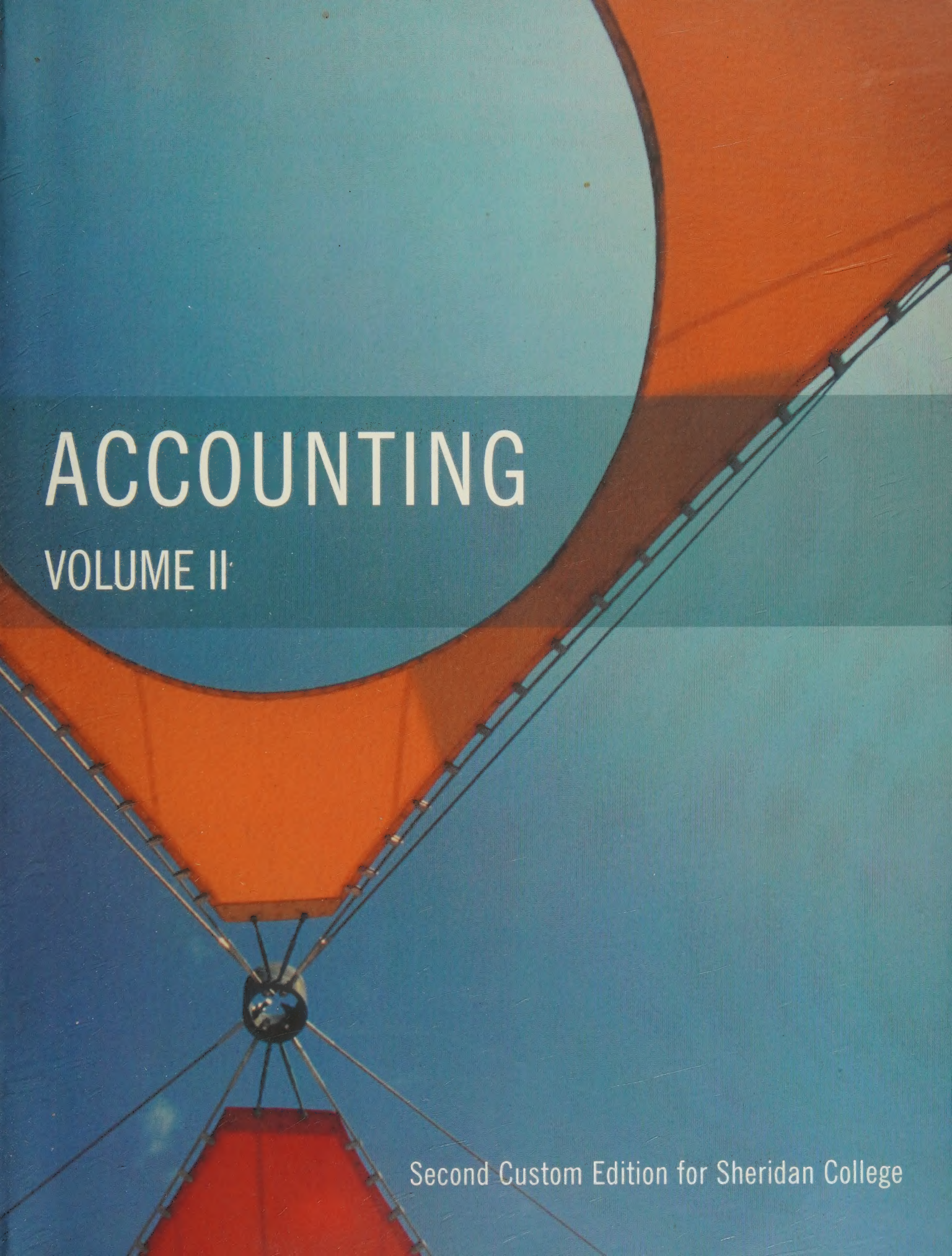


ACCOUNTING

VOLUME II

Second Custom Edition for Sheridan College

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Taken from

Accounting: Volume II, Canadian Sixth Edition
by Charles T. Horngren, Walter T. Harrison, Jr., Linda Smith Bamber, W. Morley Lemon, and Peter R. Norwood

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**Extending Your Knowledge includes Decision Problems and a Financial Statement Problem.


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CHAPTER

12

Partnerships

CHAPTER OBJECTIVES

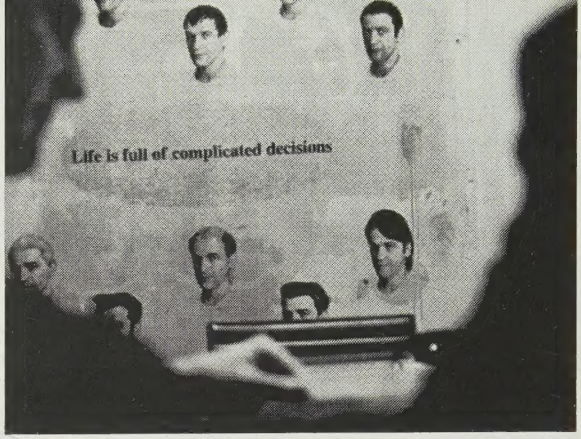
After studying this chapter, you should be able to

1. Identify the characteristics of a partnership
2. Account for partners' initial investments in a partnership
3. Allocate profits and losses to the partners by different methods
4. Account for the admission of a new partner
5. Account for the withdrawal of a partner
6. Account for the liquidation of a partnership
7. Prepare partnership financial statements



Media Companion CD-ROM

Visit the Media Companion CD-ROM that comes with this book for extra practice with the new material in Chapter 12.



Osler, Hoskin & Harcourt LLP (Limited Liability Partnership) is one of Canada's largest law firms. The firm has more than 400 lawyers located in Toronto, Ottawa, Montreal, Calgary, and New York. Its core strengths are business law, taxation, and litigation. It has provided counsel for several mergers and acquisitions for such companies as BCE Inc., Fording Inc., and AT&T Canada Inc.

How does a legal firm like Osler, Hoskin & Harcourt manage to attract such diverse and large clients? Expertise. Large companies require a myriad of legal services, and a firm like Osler, Hoskin & Harcourt can accommodate them. Each lawyer in the firm could, at least in theory, form a proprietorship and run his or her own practice. The partnership offered by Osler, Hoskin & Harcourt and other legal practice partnerships allow their lawyers to focus on their specialty but be part of a full-service firm. In other words, the partnership creates an opportunity for synergy.

Partnerships like Osler, Hoskin & Harcourt are always looking for opportunities to expand their expertise, and that is why announcements like the following are commonplace:

"Osler is pleased to announce that Michael Matheson has joined the firm as a partner in the Business Law Department and is a member of the Financial Services Practice Group. He practises in the areas of banking, syndicated lending, project finance, and mergers and acquisitions . . ."[1]

In this chapter, we will explain the partnership form of business organization and examine many of the issues with respect to its operations.

[1]From the Osler, Hoskin & Harcourt website (www.osler.ca), "New addition to financial services practice," accessed September 1, 2003.

THE PARTNERSHIP

form of business introduces some complexities that proprietorship avoids. How much cash should a new partner contribute to the business? How should the partners divide profits and losses? How should a partner who leaves the firm be compensated for her or his share of the business?

A **partnership** is an association of two or more persons who co-own a business for profit. This definition is common to the various provincial partnership acts, which tend to prescribe similar rules with respect to the organization and operation of partnerships in their jurisdictions.

Forming a partnership is easy. It requires no permission from government authorities and involves no legal procedures, with the exception that most provinces require most partnerships to register information such as the names of the partners and the name under which the business will be carried on.[1] When two persons decide to go into business together, a partnership is automatically formed.

A partnership brings together the assets, talents, and experience of the partners. Business opportunities closed to an individual may open up to a partnership. Suppose two proprietors do not have enough capital individually to buy a small building for an office. They may be able to afford it together in a partnership by pooling their talents and know-how. Their partnership thus offers clients a fuller range of services than either person can offer alone.

Partnerships come in all sizes. Many partnerships have fewer than ten partners. Some medical practices may have ten or more partners, while some of the largest law firms in Canada have more than 300 partners. The largest accounting firms in Canada have from 200 to more than 500 partners.[2] Exhibit 12-1 lists the 10 largest public accounting firms in Canada.

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[1] Smyth, J.E., D.A. Soberman, and A.J. Easson, *The Law and Business Administration in Canada*, Tenth edition (Toronto: Pearson Education Canada Inc., 2004), pp. 545–551.

[2] "Canada's Largest Corporations," *National Post Business*, June 2003, p. 142.

EXHIBIT 12-1

The Ten Largest Accounting Partnerships in Canada

Rank 2002	Firm	Revenue (Millions)	Number of Partners/ Principals
1	Deloitte & Touche LLP	$892	510
2	KPMG LLP	746	445
3	PricewaterhouseCoopers LLP	676	431
4	Ernst & Young LLP	534	265
5	Grant Thornton Canada	301	368
6	BDO Dunwoody LLP	222	329
7	Meyers Norris Penny LLP	86	100
8	Collins Barow/Mintz & Partners	84	146
9	Richter Usher & Vineberg	83	70
10	HLB/Schwartz Levitsky Feldman	42	56

Source: "Canada Largest Corporations," *National Post Business*, June 2003, p. 142.

Characteristics of a Partnership

OBJECTIVE 1
Identify the characteristics of a partnership

Starting a partnership is voluntary. A person cannot be forced to join a partnership, and partners cannot be forced to accept another person as a partner. Although the partnership agreement may be oral, a written agreement between the partners reduces the chance of a misunderstanding. The following characteristics distinguish partnerships from proprietorships and from corporations.

The Written Partnership Agreement

A business partnership is like a marriage. To be successful, the partners must cooperate. However, business partners do not vow to remain together for life. To make certain that each partner fully understands how the partnership operates and to lower the chances that any partner might misunderstand how the business is run, partners should draw up a **partnership agreement**. This agreement is a contract between the partners, so transactions under the agreement are governed by contract law. The provincial legislatures in Canada have passed their respective versions of a partnership act, the terms of which apply in the absence of a partnership agreement or in the absence of particular matters in the partnership agreement.[3]

KEY POINT

A partnership is not required to have a formal written agreement. But a written agreement prevents confusion as to the sharing of profits and losses, partners' responsibilities, admission of new partners, how the partnership will be liquidated, and so on. A written agreement does not preclude discord, however.

The partnership agreement should make the following points clear:

1. Name, location, and nature of the business
2. Name, capital investment, and duties of each partner
3. Method of sharing profits and losses among the partners
4. Withdrawals of assets allowed to the partners
5. Procedures for settling disputes among the partners
6. Procedures for admitting new partners
7. Procedures for settling with a partner who withdraws from the firm
8. Procedures for removing a partner who will not withdraw or retire from the partnership voluntarily
9. Procedures for liquidating the partnership—selling the assets, paying the liabilities, and disbursing any remaining cash to the partners

As partners enter and leave the business, the old partnership is dissolved and a new partnership is formed. Drawing up a new agreement for each new partnership may be expensive and time-consuming.

LEARNING TIP

Note that, when a partner leaves a partnership, it dissolves and its books are closed. If the remaining partners want to continue as partners, they form a new partnership with a new set of books. Dissolution does not require liquidation; that is, the assets need not be sold to outside parties.

[3] Smyth, J.E., D.A. Soberman, and A.J. Easson, *The Law and Business Administration in Canada*, Ninth edition. (Toronto: Pearson Education Canada Inc., 2001), pp. 545–558.

Limited Life

A partnership has a life limited by the length of time that all partners continue to own the business. If one partner in the chapter-opening story withdraws from the business, the partnership of Osler, Hoskin & Harcourt will cease to exist. A new partnership may emerge to continue the same business, but the old partnership will have been dissolved. **Dissolution** is the ending of a partnership. The addition of a new partner dissolves the old partnership and creates a new partnership. Large partnerships such as PricewaterhouseCoopers retain the firm name even after partners resign from the firm.

Mutual Agency

Mutual agency in a partnership means that every partner can bind the business to a contract within the scope of the partnership's regular business operations. If a partner enters into a contract with a person or another business to provide a service, then the firm—not just the partner who signed the contract—is bound to provide that service. If the partner signs a contract to purchase lawn services for his home, however, the partnership would not be bound to pay because the lawn service is a personal matter. It is not a regular business operation of the partnership.

Unlimited Liability

KEY POINT

Since all partners are personally liable for any debt of the business, it is extremely important to choose a partner carefully. This is one reason some investors/partners prefer the *limited partnership* form of business organization.

Each partner has an **unlimited personal liability** for the debts of the partnership. When a partnership cannot pay its debts with business assets, the partners must use their personal assets to meet the debt. Proprietors also have unlimited personal liability for the debts of their business.

Suppose a partnership had an unsuccessful year, and the partnership's liabilities exceed its assets by $20,000. The partners must pay this amount with their personal assets. Because each partner has *unlimited liability*, if a partner is unable to pay his or her part of the debt, the other partner (or partners) must make payment.

Unlimited liability and mutual agency are closely related. A dishonest partner or a partner with poor judgment may commit the partnership to a contract under which the business loses money. In turn, creditors may force *all* the partners to pay the debt from their personal assets. Hence, a business partner should be chosen with great care.

Partners can avoid unlimited personal liability for partnership obligations by forming a *limited partnership*. In this form of business organization, one or more of the general partners assumes the unlimited liability for business debts. In addition, there is another class of owners, limited partners, who can lose only as much as their investment in the business. In this sense, limited partners have limited liability similar to the limited liability that shareholders in a corporation have.

Co-ownership of Property

KEY POINT

A personal investment of assets in a partnership becomes the joint property of all the partners.

Any asset—cash, inventory, machinery, and so on—that a partner invests into the partnership becomes the joint property of all the partners. The partner who invested the asset is no longer its sole owner.

No Partnership Income Taxes

A partnership pays no income tax on its business income. Instead, the net income of the partnership is divided, and becomes the taxable income of the partners. Suppose a two-partner firm earned net income of $150,000, shared equally by the two partners. The partnership would pay no income tax *as a business entity*. However, each partner would pay income tax as an individual on his or her $75,000 share of partnership income.

Partners' Equity Accounts

LEARNING

A partnership is really a "multiple proprietorship." Most features of a proprietorship also apply to a partnership—in particular, limited life and unlimited liability.

Recall from Chapter 1, page 12, that owner's equity for a proprietorship has only one account, entitled "Capital." Accounting for a partnership is much like accounting for a proprietorship. We record buying and selling goods and services, collecting, and paying cash for a partnership just as we do for a proprietorship. But, because a partnership has more than one owner, the partnership must have more than one owner's equity account. Every partner in the business—whether the firm has two or two hundred partners—has an individual owner's equity account. Often these accounts carry the name of the particular partner and the word *capital*. Just as a sole proprietor has a drawings or withdrawal account (a temporary account), each partner in a partnership has a withdrawal account. If the number of partners is large, the general ledger may contain the single account Partners' Capital or Owners' Equity. In this event, a subsidiary ledger is used for individual partner accounts.

Exhibit 12-2 lists the advantages and disadvantages of partnerships (compared with proprietorships and corporations).

Types of Partnerships

There are two basic types of partnerships: general and limited.

General Partnerships

A **general partnership** is the basic form of partnership organization. Each partner is an owner of the business with all the privileges and risks of ownership. The general partners share the profits, losses, and the risks of the business. The partnership *reports* its income to governmental tax authorities (Canada Revenue Agency, or CRA), but the partnership pays *no* income tax. The profits and losses of the partnership pass through the business to the partners, who then pay personal income tax on their income.

Limited Partnerships

A **limited partnership** has at least two classes of partners. There must be at least one *general partner*, who takes primary responsibility for the management of the business. The general partner also takes the bulk of the risk of failure in the event that the partnership goes bankrupt (liabilities exceed assets). In some limited partnerships,

EXHIBIT 12-2

Advantages and Disadvantages of Partnerships

Partnership Advantages	Partnership Disadvantages
Versus Proprietorships:	1. Partnership agreement may be difficult to formulate. Each time a new partner is admitted or a partner leaves the partnership, the business needs a new partnership agreement.
1. Can raise more capital.	2. Relationships among partners may be fragile.
2. Brings together the expertise of more than one person.	3. Mutual agency and unlimited personal liability create personal obligations for each partner.
3. 1+1>2 in a good partnership. If the partners work well together, they can achieve more than by working alone.	
Versus Corporations:	
4. Less expensive to organize than a corporation, which requires articles of incorporation from a province or the federal government.	
5. Has fewer governmental regulations and restrictions than a corporation.	

such as real-estate limited partnerships, the general partner often invests little cash in the business. Instead, the general partner's contribution is her or his skill in managing the organization. Usually, the general partner is the last owner to receive a share of partnership profits and losses. But the general partner may earn all excess profits after satisfying the limited partners' demands for income.

The *limited partners* are so named because their personal obligation for the partnership's liabilities is limited to the amount they have invested in the business. Usually, the limited partners have invested the bulk of the partnership's assets and capital. They therefore usually have the first claim to partnership profits and losses, but only up to a specified limit. In exchange for their limited liability, their potential for profits usually has a limit as well.

Most of the large public accounting firms in Canada are now organized as **limited liability partnerships** (LLPs), which means that each partner's personal liability for the business's debts is limited to a certain dollar amount. An example is PricewaterhouseCoopers LLP. The LLP must carry an adequate amount of malpractice insurance to protect the public.

OBJECTIVE 2
Account for partners' initial investments in a partnership

Initial Investments by Partners

Let's examine the start up of a partnership. We will see how to account for the multiple equity accounts of the partners and learn how they should appear on the balance sheet.

Partners in a new partnership may invest assets and their related liabilities in the business. These contributions are entered in the books by recording the assets and liabilities, in the same way as proprietorships record them, at their agreed-upon values. Each person's net contribution (assets minus liabilities) is credited to the equity account for that person. Often the partners hire an independent firm to appraise their assets and liabilities at current market value at the time a partnership is formed. This outside evaluation assures an objective valuation for what each partner brings into the business.

Assume Kim Brown and Nancy Douglas form a partnership to develop and sell computer software. The partners agree on the following values based on an independent appraisal:

Brown's contributions

- Cash, $20,000; inventory, $140,000; and accounts payable, $170,000 (The appraiser believes that the current market values for these items equal Brown's book values.)
- Accounts receivable, $60,000, less allowance for doubtful accounts of $10,000
- Computer equipment: cost, $800,000; accumulated amortization, $200,000; current market value, $450,000

Douglas's contributions

- Cash, $10,000
- Computer software: cost, $36,000; current market value, $200,000

The partnership records receipts of the partners' initial investments at the current market values of the assets and liabilities because, in effect, the partnership is buying the assets and assuming the liabilities at their current market values. The partnership entries are as follows:

Brown's investment

2006				
June 1	Cash		20,000	
	Accounts Receivable		60,000	
	Inventory		140,000	
	Computer Equipment		450,000	
	Allowance for Doubtful Accounts			10,000
	Accounts Payable			170,000
	Kim Brown, Capital			490,000
	To record Brown's investment in the partnership ($670,000 – $180,000).			

Douglas's investment

2006				
June 1	Cash		10,000	
	Computer Software		200,000	
	Nancy Douglas, Capital			210,000
	To record Douglas's investment in the partnership.			

The initial partnership balance sheet reports these amounts as shown in Exhibit 12-3. Note that the asset and liability sections on the balance sheet are the same for a proprietorship and a partnership.

KEY POINT

The major difference in accounting for a proprietorship versus a partnership is the number of capital and drawing accounts. The partnership balance sheet shows a separate capital account for each partner, and there is a separate drawing account for each partner. The asset and liability sections on the balance sheet and the income statement are the same for a proprietorship and a partnership.

EXHIBIT 12-3

Partnership Balance Sheet

BROWN AND DOUGLAS
Balance Sheet
June 1, 2006

Assets			Liabilities	
Cash		$ 30,000	Accounts payable	$170,000
Accounts receivable	$60,000			
Less: Allowance for doubtful accounts	10,000	50,000	**Capital**	
Inventory		140,000	Kim Brown, capital	490,000
Computer equipment		450,000	Nancy Douglas, capital	210,000
Computer software		200,000	Total partners' equity	700,000
			Total liabilities	
Total assets		$870,000	and capital	$870,000

Stop & Think

How could a partner allow the partnership to use a personal asset, such as a car or money, without losing his or her claim to that asset?

Answer: The partner could lease the car to the partnership. If the partnership were liquidated, the car would have to be returned to its owner. The partner could also lend money to the partnership instead of investing it. Upon liquidation, the partnership would have to repay the loan to the lending partner before any distribution of capital to the partners.

Accounting and the e-World

The Lonely Life of a Dissolved Partnership

In the last edition of this textbook, the accounting firm of Arthur Andersen was listed as the sixth-largest accounting firm in Canada and was the largest accounting firm in the United States at that time. The partnership had been in existence for decades and was among the world's leading auditors. Unfortunately for Arthur Andersen partners and employees and for the accounting profession in general, the firm no longer exists.

Over the past few years, up to and including 2003, Arthur Andersen's United States practice performed a few high-profile audits that proved to be flawed. Partners in the United States signed the financial statements of several companies that had been overstating profits and assets. The United States government indicted the firm on the charge that a partner in the firm destroyed legal evidence. The ramifications were immediate and the impact was felt in Arthur Andersen offices all over the world. Many of the major clients of Arthur Andersen in the United States switched to other accounting firms and Arthur Andersen was essentially finished.

The actions of the partners in the United States caused the firm to fail all over the world. Why? The partnership form of business organization was a contributing factor. A single partner (in this case, in the United States) can commit the entire firm to a legal liability.

In Canada, Arthur Andersen merged with Deloitte & Touche, making Deloitte & Touche the largest accounting firm in this country.

OBJECTIVE 3
Allocate profits and losses to the partners by different methods

Sharing Partnership Profits and Losses

Allocating profits and losses among partners is one of the most challenging aspects of managing a partnership and can be a major source of disputes. Any division of profits and losses is allowed as long as the partners agree and it is in the partnership agreement. If the partners have not drawn up an agreement, or if the agreement does not state how the partners will divide profits and losses, then, by law, the partners must share profits and losses equally. If the agreement specifies a method for sharing profits but not losses, then losses are shared in the same proportion as profits. For example, a partner receiving 75 percent of the profits would likewise absorb 75 percent of any losses.

In some cases, an equal division is not fair. One partner may perform more work for the business than the other partner, or one partner may make a larger capital contribution. In the preceding example, Nancy Douglas might agree to work longer hours for the partnership than Kim Brown in order to earn a greater share of profits. Brown could argue that she should receive more of the profits because she contributed more net assets ($490,000) than Douglas did ($210,000). Douglas might contend that her computer software program is the partnership's most important asset, and that her share of the profits should be greater than Brown's share. Arriving at fair sharing of profits and losses in a partnership may be difficult. We now discuss the options available in determining partners' shares of profits and losses.

Sharing Based on a Stated Fraction

Partners may state a particular fraction of the total profits and losses each individual partner will share. Suppose the partnership agreement of Sarah Cagle and Bill

Elias allocates two-thirds of the business profits and losses to Cagle and one-third to Elias. If net income for the year is $540,000, and all revenue and expense accounts have been closed, the Income Summary account has a credit balance of $540,000:

Income Summary		
	Bal.	540,000

The entry to close this account and allocate the profit to the partners' capital accounts is

Dec.	31	Income Summary	540,000	
		Sarah Cagle, Capital		360,000
		Bill Elias, Capital		180,000
		To allocate net income to partners.		
		(Cagle: $540,000 × ⅔; Elias: $540,000 × ⅓)		

Consider the effect of this entry. Does Cagle get cash of $360,000 and Elias cash of $180,000? No. The increase in the capital accounts of the partners cannot be linked to any particular asset, including cash. Instead, the entry indicates that Cagle's ownership in all the assets of the business increased by $360,000 and Elias's by $180,000.

If the year's operations resulted in a net loss of $264,000, the Income Summary account would have a debit balance of $264,000. In that case, the closing entry to allocate the loss to the partners' capital accounts would be

Dec.	31	Sarah Cagle, Capital	176,000	
		Bill Elias, Capital	88,000	
		Income Summary		264,000
		To allocate net loss to partners.		
		(Cagle: $264,000 × ⅔; Elias: $264,000 × ⅓)		

Just as profit of $540,000 did not mean that the partners received cash of $360,000 and $180,000, so the loss of $264,000 does not mean that the partners must contribute cash of $176,000 and $88,000. A profit or loss will increase or decrease each partner's capital account, but cash will not change hands.

Sharing Based on Capital Investments

Profits and losses are often allocated in proportion to the partners' capital investments in the business. Suppose Jim Antoine, Erica Barber, and Tony Culomovic are partners in ABC Company. Their capital accounts have the following balances at the end of the year, before the closing entries:

Jim Antoine, Capital	$120,000
Erica Barber, Capital	180,000
Tony Culomovic, Capital	150,000
Total capital balances	$450,000

Assume that the partnership earned a profit of $360,000 for the year. To allocate this amount based on capital investments, each partner's percentage share of the partnership's total capital balance must be computed. We simply divide each partner's investment by the total capital amount. These figures, multiplied by the $360,000 profit amount, yield each partner's share of the year's profits:

Antoine:	($120,000/$450,000) × $360,000	=	$ 96,000
Barber:	($180,000/$450,000) × $360,000	=	144,000
Culomovic:	($150,000/$450,000) × $360,000	=	120,000
	Net income allocated to partners	=	$360,000

The closing entry to allocate the profit to the partners' capital accounts is

Dec.	31	Income Summary	360,000	
		Jim Antoine, Capital		96,000
		Erica Barber, Capital		144,000
		Tony Culomovic, Capital		120,000
		To allocate net income to partners.		

After this closing entry, the partners' capital balances are

Jim Antoine, Capital ($120,000 + $96,000)	$216,000
Erica Barber, Capital ($180,000 + $144,000)	324,000
Tony Culomovic, Capital ($150,000 + $120,000)	270,000
Total capital balances after allocation of net income	$810,000

Sharing Based on Capital Investments and on Service

One partner, regardless of his or her capital investment, may put more work into the business than the other partners. Even among partners who log equal service time, one person's superior experience and knowledge may command a greater share of income. To reward the harder-working or more valuable person, the profit-and-loss-sharing method may be based on a combination of invested capital *and* service to the business. Most law firms take service into account in determining partner compensation.

Assume Sheila Randolph and Carolyn Scott formed a partnership in which Randolph invested $120,000 and Scott invested $80,000, a total of $200,000. Scott devotes more time to the partnership and earns the larger salary. Accordingly, the two partners have agreed to share profits as follows:

1. The first $100,000 of partnership profits is to be allocated based on partners' capital investments in the business.
2. The next $120,000 of profits is to be allocated based on service, with Randolph receiving $48,000 and Scott receiving $72,000.
3. Any remaining amount is allocated equally.

If net income for the first year is $250,000, the partners' shares of this profit are computed as follows:

	Randolph	Scott	Total
Total net income			$250,000
Sharing of first $100,000 of net income, based on capital investments:			
Randolph ($120,000/$200,000 × $100,000)	$ 60,000		
Scott ($80,000/$200,000 × $100,000)		$ 40,000	
Total			100,000
Net income remaining for allocation			150,000
Sharing of next $120,000, based on service:			
Randolph	48,000		
Scott		72,000	
Total			120,000
Net income left for allocation			30,000
Remainder shared equally:			
Randolph ($30,000 × ½)	15,000		
Scott ($30,000 × ½)		15,000	
Total			30,000
Net income left for allocation			$ -0-
Net income allocated to the partners	$123,000	$127,000	$250,000

On the basis of this allocation, the closing entry is

Dec.	31	Income Summary	250,000	
		Sheila Randolph, Capital		123,000
		Carolyn Scott, Capital		127,000
		To allocate net income to partners.		

Sharing Based on "Salaries" and Interest

THINKING IT OVER

What factors influence the way profits and losses are shared?

A: Each partner's contribution of assets and liabilities; the fair market value of the assets contributed; the time each partner will devote to the business; the skills, abilities, reputation, clients, and such that each partner contributes.

Partners may be rewarded for their service and their capital investments to the business in other ways. In one sharing plan, the partners are allocated "salaries" (which are predetermined sums to be withdrawn, *not* employee salaries) plus interest on their capital balances. Assume Edward Massey and Pierre Vanier form an oil-exploration partnership. At the beginning of the year, their capital balances are $40,000 and $50,000 respectively. The partnership agreement allocates annual "salary" of $21,500 to Massey and $17,500 to Vanier. After these amounts are allocated, each partner earns 8 percent interest on his beginning capital balance. Any remaining net income is divided equally. Partnership profit of $48,000 for 2006 will be allocated as follows:

	Massey	Vanier	Total
Total net income			$48,000
First, "salaries":			
Massey	$21,500		
Vanier		$17,500	
Total			39,000
Net income remaining for allocation			9,000
Second, interest on beginning capital balances:			
Massey ($40,000 × 0.08)	3,200		
Vanier ($50,000 × 0.08)		4,000	
Total			7,200
Net income remaining for allocation			1,800
Third, remainder shared equally:			
Massey ($1,800 × ½)	900		
Vanier ($1,800 × ½)		900	
Total			1,800
Net income remaining for allocation			$ -0-
Net income allocated to the partners	$25,600	$22,400	$48,000

In the preceding illustration, net income exceeded the sum of "salary" and interest. If the partnership profit is less than the allocated sum of "salary" and interest, a negative remainder will occur at some stage in the allocation process. Even so, the partners use the same method for allocation purposes. For example, assume that Massey and Vanier Partnership earned only $41,000 in 2006.

	Massey	Vanier	Total
Total net income			$41,000
First, "salaries":			
Massey	$21,500		
Vanier		$17,500	
Total			39,000
Net income remaining for allocation			2,000
Second, interest on beginning capital balances:			
Massey ($40,000 × 0.08)	3,200		
Vanier ($50,000 × 0.08)		4,000	
Total			7,200
Net income remaining for allocation			(5,200)
Third, remainder shared equally:			
Massey ($5,200 × ½)	(2,600)		
Vanier ($5,200 × ½)		(2,600)	
Total			(5,200)
Net income remaining for allocation			$ -0-
Net income allocated to the partners	$22,100	$18,900	$41,000

A net loss would be allocated to Massey and Vanier in the same manner outlined for net income. The sharing procedure would begin with the net loss, and then allocate "salary," interest, and any other specified amounts to the partners.

For example, assume that Massey and Vanier Partnership had a loss of $6,000 in 2006.

REAL WORLD EXAMPLE

In some large partnerships, a "units" system of profit and loss allocation is used. Each partner is awarded a particular number of units, which becomes the numerator in the fraction used for allocation. The total number of units awarded is the denominator in the fraction. The units method can allow a partnership to continue even as partners enter and withdraw from the partnership if unit formulas (rather than partner names) are a part of the partnership agreement.

	Massey	Vanier	Total
Total net income			($6,000)
First, "salaries":			
Massey	$21,500		
Vanier		$17,500	
Total			39,000
Net income (loss) remaining for allocation			(45,000)
Second, interest on beginning capital balances:			
Massey ($40,000 × 0.08)	3,200		
Vanier ($50,000 × 0.08)		4,000	
Total			7,200
Net income (loss) remaining for allocation			(52,200)
Third, remainder shared equally:			
Massey ($52,200 × ½)	(26,100)		
Vanier ($52,200 × ½)		(26,100)	
Total			(52,200)
Net income remaining for allocation			$ -0-
Net income (loss) allocated to the partners	($1,400)	($4,600)	($6,000)

We see that partners may allocate profits and losses based on a stated fraction, invested capital, service, interest on capital, or any combination of these factors. Each partnership shapes its profit-and-loss-sharing ratio to fit its own needs.

Stop & Think

Are these "salaries" and interest amounts business expenses in the usual sense? Explain your answer.

Answer: No, partners do not work for their own business to earn a salary, as an employee does. They do not lend money to their own business to earn interest. Their goal is for the partnership to earn a profit. Therefore, "salaries" and interest in partnership agreements are simply ways of expressing the allocation of profits and losses to the partners. For example, the "salary" component of partner income rewards service to the partnership. The interest component rewards a partner's investment of cash or other assets in the business. But the partners' "salary" and interest amounts are *not* salary expense and interest expense in the partnership's accounting or tax records.

Partner Withdrawals (Drawings) of Cash and Other Assets

Like anyone else, partners need cash for personal living expenses. Partnership agreements usually allow partners to withdraw cash or other assets from the business. These withdrawals are sometimes called *drawings*, and are recorded in a separate Withdrawals or Drawings account for each partner. (Drawings from a partnership are recorded exactly as for a proprietorship.) Assume that both Edward Massey and Pierre Vanier are allowed a monthly withdrawal of $2,500. The partnership records the March 2006 withdrawal with this entry:

Mar.	31	Edward Massey, Withdrawals	2,500	
		Pierre Vanier, Withdrawals	2,500	
		Cash		5,000
		Monthly partner withdrawals of cash.		

During the year, each partner's withdrawal account accumulates 12 such amounts, a total of $30,000 ($2,500 × 12). At the end of the period, the general ledger shows the following account balances immediately after net income has been closed to the partners' capital accounts. Assume the January 1, 2006, balances for Massey and Vanier shown below, and that $41,000 of profit has been allocated on the basis of the illustration on page 665.

REAL WORLD EXAMPLE

According to the *Income Tax Act*, partners are taxed on their share of partnership income, not on the amount of their withdrawals.

Edward Massey, Capital

	Jan. 1, 2006 Bal.	40,000
	Dec. 31, 2006	
	Net income	22,100

Pierre Vanier, Capital

	Jan. 1, 2006 Bal.	50,000
	Dec. 31, 2006	
	Net income	18,900

Edward Massey, Withdrawals

Dec. 31, 2006	Bal.	30,000

Pierre Vanier, Withdrawals

Dec. 31, 2006	Bal.	30,000

The withdrawal accounts must be closed at the end of the period (as must be done for a proprietorship). The closing entry credits each partner's Withdrawals account and debits each partner's Capital account. The amount of the withdrawal does not depend on the partnership's income or loss for the year. In fact, it is possible for a partner to withdraw more than the balance in the capital account if, for example, profits were expected to be higher than they proved to be and withdrawals were made in anticipation of these high profits. This situation can only occur if the partnership has the cash required for the withdrawal and the other partners agree with the withdrawal and the ending capital balance.

Admission of a Partner

OBJECTIVE 4
Account for the admission of a new partner

A partnership lasts only as long as its partners remain in the business. The addition of a new member or the withdrawal of an existing member dissolves the partnership. We turn now to a discussion of how partnerships dissolve—and how new partnerships arise.

Often a new partnership is formed to carry on the former partnership's business. In fact, the new partnership may choose to retain the dissolved partnership's name. PricewaterhouseCoopers LLP, for example, is an accounting firm that retires and admits partners during the year. Thus the former partnership dissolves and a new partnership begins many times. The business, however, retains the name and continues operations. Other partnerships may dissolve and then re-form under a new name. Let's look at the ways that a new member may gain admission into an existing partnership.

Admission by Purchasing a Partner's Interest

A person may become a member of a partnership by gaining the approval of the other partner (or partners) for entrance into the firm, *and* by purchasing a present partner's interest in the business. Let's assume that Stephi Fisher and Carlo Levesque have a partnership that carries these figures:

Cash	$100,000	Total liabilities	$240,000
Other assets	720,000	Stephi Fisher, capital	230,000
		Carlo Levesque, capital	350,000
Total assets	$820,000	Total liabilities and capital	$820,000

Business is so successful that Fisher receives an offer from Linda Dynak, an outside party, to buy her $230,000 interest in the business for $300,000. Fisher agrees to sell out to Dynak, and Levesque approves Dynak as a new partner. The firm records the transfer of capital interest in the business with this entry:

Apr.	16	Stephi Fisher, Capital	230,000	
		Linda Dynak, Capital		230,000
		To transfer Fisher's equity in the business to Dynak.		

The debit side of the entry closes Fisher's capital account because she is no longer a partner in the firm. The credit side opens Dynak's capital account because Fisher's equity has been transferred to Dynak. The entry amount is Fisher's capital balance ($230,000) and not the $300,000 price that Dynak paid Fisher to buy into the business. The full $300,000 goes to Fisher, including the $70,000 difference between her capital balance and the price received from Dynak. In this example, the partnership does not receive cash because the transaction was between Dynak and Fisher, not between Dynak and the partnership. Suppose Dynak pays Fisher less than Fisher's capital balance. The entry on the partnership books is not affected. Fisher's equity is transferred to Dynak at book value ($230,000).

KEY POINT

The profit or loss on the sale of a partnership interest belongs personally to the partner selling the interest and will not appear on the partnership's books.

The old partnership has dissolved. Levesque and Dynak draw up a new partnership agreement, with a new profit-and-loss-sharing ratio, and continue business operations. If Levesque does not accept Dynak as a partner, the Fisher and Levesque partnership would be dissolved, and Dynak would be unable to buy Fisher's interest.

Admission by Investing in the Partnership

A person may be admitted as a partner by investing directly in the partnership rather than by purchasing an existing partner's interest. The new partner contributes assets—for example, cash, inventory, or equipment—to the business. Assume that the partnership of Robin Ingel and Michael Jay has the following assets, liabilities, and capital:

Cash	$ 45,000	Total liabilities	$135,000
Other assets	450,000	Robin Ingel, capital	157,500
		Michael Jay, capital	202,500
Total assets	$495,000	Total liabilities and capital	$495,000

Laureen Kahn offers to invest equipment and land (Other assets) with a market value of $180,000 to persuade the existing partners to take her into the business. Ingel and Jay agree to dissolve the existing partnership and to start up a new business, giving Kahn one-third interest—[$180,000/($157,500 + $202,500 + $180,000) = ⅓]—in exchange for the contributed assets. Notice that Kahn is buying into the partnership at book value because her one-third investment ($180,000) equals one-third of the new partnership's total capital ($360,000). The entry to record Kahn's investment is

July	18	Other Assets	180,000	
		Laureen Kahn, Capital		180,000
		To admit L. Kahn as a partner with a one-third interest in the business.		

After this entry, the partnership books show:

Cash	$ 45,000	Total liabilities	$135,000
Other assets ($450,000 + $180,000)	630,000	Robin Ingel, capital	157,500
		Michael Jay, capital	202,500
		Laureen Kahn, capital	180,000
Total assets	$675,000	Total liabilities and capital	$675,000

Kahn's one-third interest in the partnership does not necessarily entitle her to one-third of the profits. The sharing of profits and losses is a separate element in the partnership agreement.

Admission by Investing in the Partnership—Bonus to the Old Partners The more successful a partnership, the higher the payment the partners may demand from a person entering the business. Partners in a business that is doing quite well might require an incoming person to pay them a bonus. The bonus comes into the partnership, increasing the current partners' capital accounts.

Suppose that Hiro Nagasawa and Lisa Schwende's partnership has earned above-average profits for ten years. The two partners share profits and losses equally. The balance sheet carries these figures:

Cash	$ 160,000	Total liabilities	$ 400,000
Other assets	840,000	Hiro Nagasawa, capital	280,000
		Lisa Schwende, capital	320,000
		Total liabilities	
Total assets	$1,000,000	and capital	$1,000,000

The partners agree to admit Alana Parker to a one-fourth interest with her cash investment of $360,000. Parker's capital balance on the partnership books is $240,000, computed as follows:

Partnership capital before Parker is admitted ($280,000 + $320,000)	$600,000
Parker's investment in the partnership	360,000
Partnership capital after Parker is admitted	$960,000
Parker's capital in the partnership ($960,000 × ¼)	$240,000
Bonus to the old partners ($360,000 – $240,000)	$120,000

LEARNING

Notice in the March 1 journal entry that Nagasawa's and Schwende's capital accounts increased because of Parker's investment, but that Nagasawa and Schwende have not received cash. All the cash went into the partnership. Their increased capital accounts include the bonus amount contributed by Parker.

In effect, Parker had to buy into the partnership at a price ($360,000) above the book value of her one-fourth interest ($240,000). Parker's extra investment of $120,000 creates a *bonus* for the existing partners. The entry on the partnership books to record Parker's investment is

Mar.	1	Cash	360,000	
		Alana Parker, Capital		240,000
		Hiro Nagasawa, Capital		60,000
		Lisa Schwende, Capital		60,000
		To admit A. Parker as a partner with a one-fourth interest in the business. Nagasawa and Schwende each receive a bonus of $60,000 ($120,000 × ½).		

LEARNING

The bonus in this example is shared equally by the existing partners because they share profits and losses equally. A bonus is normally shared by the existing partners in the profit-sharing ratio.

Parker's capital account is credited for her one-fourth interest in the partnership. The bonus is allocated to the original partners (Nagasawa and Schwende) based on their profit-and-loss ratio.

The new partnership's balance sheet reports these amounts:

Cash ($160,000 + $360,000)	$ 520,000	Total liabilities	$ 400,000
Other assets	840,000	Hiro Nagasawa, capital ($280,000 + $60,000)	340,000
		Lisa Schwende, capital ($320,000 + $60,000)	380,000
		Alana Parker, capital	240,000
		Total liabilities	
Total assets	$1,360,000	and capital	$1,360,000

Admission by Investing in the Partnership—Bonus to the New Partner A potential new partner may be so important that the existing partners offer him or her a partnership share that includes a bonus. A law firm may strongly desire a former

premier, cabinet minister, or other official as a partner because of the person's reputation. A restaurant owner may want to go into partnership with a famous sports personality like Wayne Gretzky or a singer like Shania Twain.

Suppose Jenny Page and Miko Osuka have a law partnership. The firm's balance sheet appears as follows:

Cash	$105,000	Total liabilities	$ 90,000
Other assets	270,000	Jenny Page, capital	172,500
		Miko Osuka, capital	112,500
		Total liabilities	
Total assets	$375,000	and capital	$375,000

The partners admit Martin Schiller, a former provincial Finance Minister, as a partner with a one-third interest in exchange for his cash investment of $75,000. At the time of Schiller's admission, the firm's capital is $285,000—Page, $172,500 plus Osuka, $112,500. Page and Osuka share profits and losses in the ratio of two-thirds to Page and one-third to Osuka. The computation of Schiller's equity in the partnership is

Partnership capital before Schiller is admitted ($172,500 + $112,500)	$285,000
Schiller's investment in the partnership	75,000
Partnership capital after Schiller is admitted	$360,000
Schiller's capital in the partnership ($360,000 × ⅓)	$120,000
Bonus to new partner ($120,000 – $75,000)	$ 45,000

In this case, Schiller bought into the partnership at a price ($75,000) below the book value of his interest ($120,000). The bonus of $45,000 went to Schiller from the other partners. The capital accounts of Page and Osuka are debited for the $45,000 difference between the new partner's equity ($120,000) and his investment ($75,000). The existing partners share this decrease in capital, which is accounted for as though it were a loss, based on their profit-and-loss ratio. The entry to record Schiller's investment is

Aug. 24	Cash	75,000	
	Jenny Page, Capital ($45,000 × ⅔)	30,000	
	Miko Osuka, Capital ($45,000 × ⅓)	15,000	
	Martin Schiller, Capital		120,000
	To admit M. Schiller as a partner with a one-third interest in the business.		

The new partnership's balance sheet reports these amounts:

Cash ($105,000 + $75,000)	$180,000	Total liabilities	$ 90,000
Other assets	270,000	Jenny Page, capital ($172,500 – $30,000)	142,500
		Miko Osuka, capital ($112,500 – $15,000)	97,500
		Martin Schiller, capital	120,000
		Total liabilities	
Total assets	$450,000	and capital	$450,000

OBJECTIVE 5
Account for the withdrawal of a partner

Withdrawal of a Partner from the Business

A partner may withdraw from the business for many reasons, including retirement or a dispute with the other partners. The withdrawal of a partner dissolves the old partnership. The partnership agreement should contain a provision to govern how

to settle with a withdrawing partner. In the simplest case, as illustrated on page 667, a partner may withdraw and sell his or her interest to another partner in a personal transaction. The only entry needed to record this transfer of equity debits the withdrawing partner's capital account and credits the purchaser's capital account. The dollar amount of the entry is the capital balance of the withdrawing partner, regardless of the price paid by the purchaser. The accounting when one current partner buys a second partner's interest is the same as when an outside party buys a current partner's interest.

KEY POINT

When a partner leaves a partnership, she or he ceases to be an agent and no longer has the authority to bind the business to contracts. Third parties with whom the partnership has dealt should be notified that the exiting partner no longer can bind the partnership. For all other third parties, constructive notice, such as an advertisement in the newspaper, is sufficient.

If the partner withdraws in the middle of the accounting period, the partnership books should be updated to determine the withdrawing partner's capital balance. The business must measure net income or net loss for the fraction of the year up to the withdrawal date, and allocate profit or loss according to the existing ratio. An alternative is to set an amount in the partnership agreement to be allocated regardless of the final annual results. This could be appropriate in businesses that have seasonal fluctations, where the selection of withdrawal date could lead to unfair allocations. After the books have been closed, the business then accounts for the change in partnership capital.

The withdrawing partner may receive his or her share of the business in partnership assets other than cash. The question then arises of what value to assign the partnership assets—book value or current market value? The settlement procedure may specify an independent appraisal of the assets to determine their current market value. If market values have changed, the appraisal will result in a revaluing of the partnership assets. Thus the partners share in any market value changes that their efforts caused.

Suppose Ben Isaac is retiring in midyear from the partnership of Green, Maslowski, and Isaac. After the books have been adjusted for partial-period income but before the asset appraisal, revaluation, and closing entries are recorded, the balance sheet reports the following:

Cash		$104,000	Total liabilities	$186,000
Inventory		88,000	Joan Green, capital	108,000
Land		110,000	Ivan Maslowski, capital	86,000
Building	$190,000		Ben Isaac, capital	42,000
Less: Accumulated amortization	70,000	120,000	Total liabilities and capital	$422,000
Total assets		$422,000		

An independent appraiser revalues the inventory at $76,000 (down from $88,000), and the land at $202,000 (up from $110,000). The partners share the differences between these assets' market values and their prior book values based on their profit-and-loss ratio.

The partnership agreement has allocated one-fourth of the profits to Green, one-half to Maslowski, and one-fourth to Isaac. (This ratio may be written 1:2:1 for one part to Green, two parts to Maslowski, and one part to Isaac.) For each share that Green or Isaac has, Maslowski has two. The entries to record the revaluation of the inventory and land are

June	30	Joan Green, Capital ($12,000 × ¼)	3,000	
		Ivan Maslowski, Capital ($12,000 × ½)	6,000	
		Ben Isaac, Capital ($12,000 × ¼)	3,000	
		Inventory ($88,000 – $76,000)		12,000
		To revalue the inventory and allocate the loss in value to the partners.		
June	30	Land ($202,000 – $110,000)	92,000	
		Joan Green, Capital ($92,000 × ¼)		23,000
		Ivan Maslowski, Capital ($92,000 × ½)		46,000
		Ben Isaac, Capital ($92,000 × ¼)		23,000
		To revalue the land and allocate the gain in value to the partners.		

After the revaluations, the partnership balance sheet reports:

Cash		$104,000	Total liabilities	$186,000
Inventory		76,000	Joan Green, capital ($108,000 – $3,000 + $23,000)	128,000
Land		202,000	Ivan Maslowski, capital ($86,000 – $6,000 + $46,000)	126,000
Building	$190,000		Ben Isaac, capital ($42,000 – $3,000 + $23,000)	62,000
Less: Accumulated amortization	70,000	120,000	Total liabilities and capital	$502,000
Total assets		$502,000		

The books now carry the assets at current market value, which becomes the new book value, and the capital accounts have been adjusted accordingly. As the balance sheet shows, Isaac has a claim to $62,000 in partnership assets. How is his withdrawal from the business accounted for?

Withdrawal at Book Value

If Ben Isaac withdraws by taking cash equal to the book value of his owner's equity, the entry would be

June	30	Ben Isaac, Capital	62,000	
		Cash		62,000
		To record the withdrawal of B. Isaac from the partnership.		

This entry records the payment of partnership cash to Isaac and the closing of his capital account upon his withdrawal from the business.

Withdrawal at Less Than Book Value

The withdrawing partner may be so eager to leave the business that she or he is willing to take less than her or his equity. Assume Ben Isaac withdraws from the business, and agrees to take partnership cash of $20,000 and the new partnership's note for $30,000. This $50,000 settlement is $12,000 less than Isaac's $62,000 equity in the business. The remaining partners share this $12,000 difference—which is a bonus to them—according to their profit-and-loss ratio.

Because Isaac has withdrawn from the partnership, a new agreement—and a new profit-and-loss ratio—must be drawn up. Maslowski and Green, in forming a new partnership, may decide on any ratio that they see fit. Let's assume they agree that Maslowski will earn two-thirds of partnership profits and losses, and Green one-third. The entry to record Isaac's withdrawal at less than book value is

June	30	Ben Isaac, Capital	62,000	
		Cash		20,000
		Note Payable to Ben Isaac		30,000
		Joan Green, Capital		4,000
		Ivan Maslowski, Capital		8,000
		To record withdrawal of B. Isaac from the partnership. Green's bonus is $4,000 ($12,000 × ⅓) and Maslowski's bonus is $8,000 ($12,000 × ⅔).		

Isaac's account is closed, and Maslowski and Green may or may not continue the business as a new partnership.

Withdrawal at More Than Book Value

The settlement with a withdrawing partner may allow him or her to take assets of greater value than the book value of that partner's capital. Also, the remaining

partners may be so eager for the withdrawing partner to leave the firm that they pay the partner a bonus to withdraw from the business. In either case, the partner's withdrawal causes a decrease in the book equity of the remaining partners. This decrease is allocated to the partners based on their profit-and-loss ratio.

The accounting for this situation follows the pattern illustrated for withdrawal at less than book value—with one exception. The remaining partners' capital accounts are debited because the withdrawing partner receives more than his or her book equity.

Suppose Linda is withdrawing from the partnership of Linda, Jacob, and Karla. The partners share profits and losses in a 1:2:3 ratio for Linda, Jacob, and Karla, respectively. After the revaluation of assets, Linda's capital balance is $200,000, and the other partners agree to pay her $240,000. The journal entry to record the payment to Linda and her withdrawal from the partnership is

	Linda, Capital	200,000	
	Jacob, Capital	16,000	
	Karla, Capital	24,000	
	Cash		240,000
	To record withdrawal of Linda from the business. Jacob's capital is reduced by $16,000 [($240,000 – $200,000) × 2/6] and Karla's capital is reduced by $24,000 [($240,000 – $200,000) × 3/6].		

Death of a Partner

Like any other form of partnership withdrawal, the death of a partner dissolves a partnership. The partnership accounts are adjusted to measure net income or loss for the fraction of the year up to the date of death, then closed to determine the partners' capital balances on that date. Settlement with the deceased partner's estate is based on the partnership agreement. The estate commonly receives partnership assets equal to the partner's capital balance. The partnership closes the deceased partner's capital account with a debit. This entry credits a payable to the estate.

REAL WORLD EXAMPLE

Partners commonly carry life insurance on themselves, with the partners as beneficiaries. In the event of a death, the partners receive the cash flow necessary to settle with the deceased partner's estate, without putting the partnership into financial jeopardy.

Suppose Joan Green (of the partnership on page 671) dies after all accounts have been adjusted to current market value. Green's capital balance is $128,000. Green's estate may request cash for her final share of the partnership's assets. At this time the business has only $104,000 of cash, so it must borrow. Let's assume the partnership borrows $100,000 and then pays Green's estate for her capital balance. The partnership's journal entries are

July 1		Cash	100,000	
		Note payable		100,000
		To borrow money.		
July 1		Joan Green, Capital	128,000	
		Cash		128,000
		To record withdrawal of Green from the business.		

Alternatively, a remaining partner may purchase the deceased partner's equity. The deceased partner's equity is debited and the purchaser's equity is credited. The amount of this entry is the ending credit balance in the deceased partner's capital account.

Liquidation of a Partnership

OBJECTIVE 6
Account for the liquidation of a partnership

Admission of a new partner or withdrawal or death of an existing partner dissolves the partnership. However, the business may continue operating with no apparent change to outsiders such as customers and creditors. In contrast, business **liquidation**

KEY POINT

Remember that the profit-and-loss ratio is used to divide gains and losses. The partners' capital balances are used to divide assets.

When a business liquidates there may not be enough cash to pay the liabilities. The partners (who are personally liable for the partnership debts) must contribute cash on the basis of their profit-and-loss ratio to cover unpaid debts.

is the process of going out of business by selling the entity's assets and paying its liabilities. The final step in liquidation of a business is the *distribution of the remaining cash to the owners*. Before the business is liquidated, the books should be adjusted and closed. After closing, only asset, liability, and partners' capital accounts remain open.

Liquidation of a partnership includes three basic steps:

1. Sell the assets. Allocate the gain or loss to the partners' capital accounts based on the profit-and-loss ratio.
2. Pay the partnership liabilities.
3. Disburse the remaining cash to the partners in proportion to their capital balances.

In actual practice, the liquidation of a business can stretch over weeks or months. Selling every asset and paying every liability of the entity takes time. For example, the liquidation of a law firm of over 75 partners took almost a year.

To avoid excessive detail in our illustrations, we include only two asset categories—Cash and Noncash Assets—and a single liability category—Liabilities. Our examples also assume that the business sells the noncash assets in a single transaction and pays the liabilities in a single transaction. (In actual practice, each asset and its related amortization would be accounted for separately when it is sold, and each liability would be accounted for separately when it is paid.)

KEY POINT

Partners' profit-and-loss ratio need not match the partners' capital balances. Here, for example, Jane Aviron has a 60 percent sharing ratio but owns $^4/_7$ (or 57 percent) of the capital.

Assume that Jane Aviron, Elaine Bloch, and Kim Zhang have shared profits and losses in the ratio of 3:1:1. (This ratio is equal to $^3/_5$, $^1/_5$, $^1/_5$, or a 60-percent, 20-percent, 20-percent sharing ratio.) They decide to liquidate their partnership. After the books are adjusted and closed, the general ledger contains the following balances:

Cash	$ 30,000	Liabilities	$ 90,000
Noncash assets	270,000	Jane Aviron, capital	120,000
		Elaine Bloch, capital	60,000
		Kim Zhang, capital	30,000
		Total liabilities	
Total assets	$300,000	and capital	$300,000

Sale of Noncash Assets at a Gain

Assume the Aviron, Bloch, and Zhang partnership sells its noncash assets (shown on the balance sheet at $270,000) for cash of $450,000. The partnership realizes a gain of $180,000, which is allocated to the partners based on their profit-and-loss-sharing ratio. The entry to record this sale and allocation of the gain is

Oct.	31	Cash	450,000	
		Noncash Assets		270,000
		Jane Aviron, Capital		108,000
		Elaine Bloch, Capital		36,000
		Kim Zhang, Capital		36,000
		To sell noncash assets in liquidation and allocate gain to partners. Aviron's share of the gain is $108,000 ($180,000 × 0.60), Bloch's and Zhang's are $36,000 ($180,000 × 0.20).		

The partnership must next pay off its liabilities:

Oct.	31	Liabilities	90,000	
		Cash		90,000
		To pay liabilities in liquidation.		

In the final liquidation transaction, the remaining cash is disbursed to the partners. *The partners share in the cash according to their capital balances.* (By contrast, *gains* and *losses* on the sale of assets are shared by the partners based on their

profit-and-loss-sharing ratio.) The amount of cash left in the partnership is $390,000—the $30,000 beginning balance plus the $450,000 cash sale of assets minus the $90,000 cash payment of liabilities. The partners divide the remaining cash according to their capital balances:

Oct.	31	Jane Aviron, Capital ($120,000 + $108,000)	228,000	
		Elaine Bloch, Capital ($60,000 + $36,000)	96,000	
		Kim Zhang, Capital ($30,000 + $36,000)	66,000	
		Cash		390,000
		To disburse cash to partners in liquidation.		

A convenient way to summarize the transactions in a partnership liquidation is given in Exhibit 12-4.

After the disbursement of cash to the partners, the business has no assets, liabilities, or owners' equity. All the balances are zero. By the accounting equation, partnership assets *must* equal partnership liabilities plus partnership capital.

LEARNING

Keep in mind that, upon liquidation, gains on the sale of assets are divided according to the profit-and-loss ratio. The final cash disbursement is based on capital balances.

Sale of Noncash Assets at a Loss

Liquidation of a business often includes the sale of noncash assets at a loss. When this occurs, the partners' capital accounts are debited as they share the loss in their profit-and-loss-sharing ratio. Otherwise, the accounting follows the pattern illustrated for the sale of noncash assets at a gain.

Partnership Financial Statements

OBJECTIVE 7
Prepare partnership financial statements

Partnership financial statements are much like those of a proprietorship. However, a partnership income statement includes a section showing the division of net income to the partners. For example, the partnership of Leslie Gray and Andrew Hui might report its income statement for the year ended December 31, 2006, as shown in Panel A of Exhibit 12-5 on page 676. A proprietorship's financial statements are presented in Panel B for comparison.

Large partnerships may not find it feasible to report the net income of every partner. Instead, the firm may report the allocation of net income to active and retired partners and average earnings per partner. For example, Exhibit 12-6 shows how the accounting and consulting firm of Main, Price & Anders reported its earnings.

The Decision Guidelines feature on pages 677–678 summarizes the main points of accounting for partnerships.

EXHIBIT 12-4

Partnership Liquidation—Sale of Assets at a Gain

				Capital		
	Cash	+ Noncash Assets	= Liabilities	+ *Aviron (60%)*	+ *Bloch (20%)*	+ *Zhang (20%)*
Balances before sale of assets	$ 30,000	$270,000	$ 90,000	$120,000	$60,000	$ 30,000
Sale of assets and sharing of gain	450,000	(270,000)		108,000	36,000	36,000
Balances	480,000	-0-	90,000	228,000	96,000	66,000
Payment of liabilities	(90,000)		(90,000)			
Balances	390,000	-0-	-0-	228,000	96,000	66,000
Disbursement of cash to partners	(390,000)			(228,000)	(96,000)	(66,000)
Balances	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-

EXHIBIT 12-5

Financial Statements of a Partnership and a Proprietorship

Panel A—Partnership

GRAY AND HUI CONSULTING
Income statement
For the Year Ended December 31, 2006

Revenues		$460
Expenses		(270)
Net income		$190
Allocation of net income:		
To Leslie Gray	$114	
To Andrew Hui	76	$190

GRAY AND HUI CONSULTING
Statement of Owners' Equity
For the Year Ended December 31, 2006

	Gray	Hui
Capital, January 1, 2006	$ 50	$40
Additional investments	10	—
Net income	114	76
Subtotal	174	116
Withdrawals	(72)	(48)
Capital, December 31, 2006	$102	$68

GRAY AND HUI CONSULTING
Balance Sheet
December 31, 2006

Assets	
Cash and other assets	$170
Partners' Equity	
Leslie Gray, capital	**$102**
Andrew Hui, capital	**68**
Total capital	$170

Panel B—Proprietorship

GRAY CONSULTING
Income statement
For the Year Ended December 31, 2006

Revenues	$460
Expenses	(270)
Net income	$190

GRAY CONSULTING
Statement of Owner's Equity
For the Year Ended December 31, 2006

Capital, January 1, 2006	$ 90
Additional investments	10
Net income	190
Subtotal	290
Withdrawals	(120)
Capital, December 31, 2006	$170

GRAY CONSULTING
Balance Sheet
December 31, 2006

Assets	
Cash and other assets	$170
Owner's Equity	
Leslie Gray, capital	$170

EXHIBIT 12-6

Reporting Net Income for a Large Partnership

MAIN, PRICE & ANDERS
Combined Statement of Earnings
For the Year Ended August 31, 2005

Fees for Professional Services	$9,144,920
Earnings for the year	$2,978,800
Allocation of earnings	
To partners active during the year—	
Resigned, retired, and deceased partners	$ 199,010
Partners active at year end	2,620,291
To retired and deceased partners—	
Retirement and death benefits	83,100
Not allocated to partners—retained for specific partnership purposes	76,399
	$2,978,800
Average earnings per partner at year end (28 partners)	$ 106,400

Stop & Think

Suppose the Aviron, Bloch, and Zhang partnership sold its noncash assets for $90,000 and all other details in Exhibit 12-4 remained the same. This creates a loss of $180,000 on the sale of the noncash assets. Allocate the loss to the partners. Identify ways that the partnership could deal with the negative balance (a capital deficiency) in Zhang's capital account.

Answer: Allocation of the $120,000 loss on the sale of assets is shown below.

					Capital		
	Cash +	Noncash Assets =	Liabilities +	Aviron (60%) +	Bloch (20%) +	Zhang (20%)
Balances before sale of assets	$ 30,000	$270,000	$ 90,000	$120,000	$ 60,000	$ 30,000
Sale of assets and sharing of loss	90,000	(270,000)		(108,000)	(36,000)	(36,000)
Balances	120,000	-0-	90,000	12,000	24,000	(6,000)
Payment of liabilities	(90,000)		(90,000)			
Balances	30,000	-0-	-0-	12,000	24,000	(6,000)
Disbursement of cash to partners	(30,000)			(12,000)	(24,000)	6,000
Balances	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-

To deal with the $6,000 capital deficiency in Zhang's Capital account, two possibilities are:

1. Zhang could contribute assets to the partnership in an amount equal to her capital deficiency. If Zhang contributed cash, the journal entry to record this is

Cash	6,000	
Kim Zhang, Capital		6,000

2. Kim Zhang's partners, Jane Aviron and Elaine Bloch, could agree to absorb Zhang's capital deficiency by decreasing their own capital balances in proportion to their remaining profit-sharing percentages: Aviron, 60/80; Bloch, 20/80. The journal entry to record this is

Jane Aviron, Capital	4,500	
Elaine Bloch, Capital	1,500	
Kim Zhang, Capital		6,000

Decision Guidelines — Accounting for Partnerships

Decision	Guidelines
How should the business be organized?	A partnership offers both advantages and disadvantages in comparison with proprietorships and corporations. (See Exhibit 12–2, page 659.)
On what matters should the partners agree?	See the list on page 657, under the heading "The Written Partnership Agreement."
At what value does the partnership record assets and liabilities?	Current market value on the date of acquisition, because, in effect, the partnership is buying its assets at their current market value.
How are partnership profits and losses shared among the partners?	• Equally if there is no profit-and-loss-sharing agreement. • As provided in the partnership agreement. Can be based on the partners' a. Stated fractions b. Capital investments c. Service to the partnership d. "Salaries" and interest on their capital investments
What happens when a partner withdraws from the partnership?	The old partnership ceases to exist. The remaining partners may or may not form a new partnership.

How are new partners admitted to the partnership?	• *Purchase a partner's interest.* The old partnership is dissolved. The remaining partners may admit the new partner to the partnership. If not, the new partner gets no voice in the management of the firm but shares in the profits and losses of the partnership. Close the withdrawing partner's Capital account, and open a Capital account for the new partner. Carry over the old partner's Capital balance to the Capital account of the new partner. • *Invest in the partnership.* Buying in at book value creates no bonus to any partner. Buying in at a price above book value creates a bonus to the old partners. Buying in at a price below book value creates a bonus for the new partner.
How should the withdrawal of a partner from the business be accounted for?	• First, adjust and close the books up to the date of the partner's withdrawal from the business. • Second, appraise the assets and the liabilities to determine their current market value. • Third, account for the partner's withdrawal a. At book value (no change in remaining partners' Capital balances) b. At less than book value (increase the remaining partners' Capital balances) c. At more than book value (decrease the remaining partners' Capital balances)
What happens if the partnership goes out of business?	Liquidate the partnership, as follows: a. Adjust and close the partnership books up to the date of liquidation. b. Sell the partnership's assets. Allocate gain or loss to the partners' Capital accounts based on their profit-and-loss-sharing ratio. c. Pay the partnership liabilities. d. Pay any remaining cash to the partners based on their Capital balances.
How do partnership financial statements differ from those of a proprietorship?	• The partnership income statement reports the allocation of net income or net loss to the partners. • The partnership balance sheet (or a separate schedule) reports the Capital balance of each partner. • The cash flow statement is the same for a partnership as for a proprietorship.

Summary Problem for Your Review

The partnership of Taylor and Uvalde is considering admitting Steven Vaughn as a partner on January 2, 2005. The partnership general ledger includes the following balances on that date:

Cash	$ 36,000	Total liabilities	$200,000
Other assets	440,000	Debby Taylor, capital	180,000
		Thomas Uvalde, capital	96,000
Total assets	$476,000	Total liabilities and capital	$476,000

Debby Taylor's share of profits and losses is 60 percent and Thomas Uvalde's share is 40 percent.

(Items 1 and 2 are independent.)

1. Suppose Vaughn pays Uvalde $124,000 to acquire Uvalde's interest in the business after Taylor approves Vaughn as a partner.
   a. Record the transfer of owner's equity on the partnership books.
   b. Prepare the partnership balance sheet immediately after Vaughn is admitted as a partner.
2. Suppose that Vaughn becomes a partner by investing $124,000 cash to acquire a one-fourth interest in the business.
   a. Compute Vaughn's capital balance and record his investment in the business.
   b. Prepare the partnership balance sheet immediately after Vaughn is admitted as a partner. Include the appropriate heading.
3. Which way of admitting Vaughn to the partnership increases its total assets? Give your reason.

Solution

a. 2005

Jan.	2	Thomas Uvalde, Capital	96,000	
		Steven Vaughn, Capital		96,000
		To transfer Uvalde's equity in the partnership to Vaughn.		

b. The balance sheet for the partnership of Taylor and Vaughn is identical to the balance sheet given for Taylor and Thomas Uvalde in the problem, except Steven Vaughn's name replaces Thomas Uvalde's name in the title and in the listing of Capital accounts.

a. Computation of Vaughn's capital balance:

Partnership capital before Vaughn is admitted ($180,000 + $96,000)	$276,000
Vaughn's investment in the partnership	124,000
Partnership capital after Vaughn is admitted	$400,000
Vaughn's capital in the partnership ($400,000 × ¼)	$100,000

2005

Jan.	2	Cash	124,000	
		Steven Vaughn, Capital		100,000
		Debby Taylor, Capital		14,400
		Thomas Uvalde, Capital		9,600
		To admit Vaughn as a partner with a one-fourth interest in the business. Taylor's bonus is $14,400 [($124,000 – $100,000) × 0.60] and Uvalde's bonus is $9,600 [($124,000 – $100,000) × 0.40].		

b.

TAYLOR, UVALDE, AND VAUGHN
Balance Sheet
January 2, 2005

Cash*	$160,000	Total liabilities	$200,000
Other assets	440,000	Debby Taylor, capital**	194,400
		Thomas Uvalde, capital***	105,600
		Steven Vaughn, capital	100,000
		Total liabilities	
Total assets	$600,000	and capital	$600,000

*$ 36,000 + $124,000 = $160,000
**$180,000 + $ 14,400 = $194,400
***$ 96,000 + $ 9,600 = $105,600

Vaughn's investment in the partnership increases its total assets by the amount of his contribution. Total assets of the business are $600,000 after his investment, compared with $476,000 before. By contrast, Vaughn's purchase of Uvalde's interest in the business is a personal transaction between the two individuals. It does not affect the assets of the partnership regardless of the amount Vaughn pays Uvalde.

Cyber Coach

Visit the Study Guide on the Media Companion CD-ROM and the Student Resources area of the *Accounting* Companion Website for extra practice with the new material in Chapter 12.

www.pearsoned.ca/horngren

Summary

1. **Identify the characteristics of a partnership.** A *partnership* is a business co-owned by two or more persons for profit. The characteristics of this form of business organization are its *ease of formation, limited life, mutual agency, unlimited liability,* and *no partnership income taxes.* In a *limited partnership*, the limited partners have limited personal liability for the obligations of the business.

   A written *partnership agreement* establishes procedures for admission of a new partner, withdrawals of a partner, and the sharing of profits and losses among the partners. When a new partner is admitted to the firm or an existing partner withdraws, the old partnership is *dissolved*, or ceases to exist. A new partnership may or may not emerge to continue the business.

2. **Account for partners' initial investments in a partnership.** Accounting for a partnership is similar to accounting for a proprietorship. However, a partnership has more than one owner. Each partner has an individual capital account and a withdrawal account.

3. **Allocate profits and losses to the partners by different methods.** Partners share net income or loss in any manner they choose. Common sharing agreements base the *profit-and-loss ratio* on a stated fraction, partners' capital investments, and/or their service to the partnership. Some partnerships call the cash withdrawals of partners *salaries* and *interest*, but these amounts are not expenses of the business. Instead, they are merely ways to describe the allocation of partnership net income to the partners.

4. **Account for the admission of a new partner.** An outside person may become a partner by purchasing a current partner's interest or by investing in the partnership. In some cases the new partner must pay the current partners a bonus to join. In other situations the new partner may receive a bonus to join.

5. **Account for the withdrawal of a partner.** When a partner withdraws, partnership assets may be reappraised. Partners share any gain or loss on the asset revaluation on the basis of their profit-and-loss ratio. The withdrawing partner may receive payment equal to, greater than, or

less than her or his capital book value, depending on the agreement with the other partners.

6. **Account for the liquidation of a partnership.** In *liquidation*, a partnership goes out of business by selling the assets, paying the liabilities, and disbursing any remaining cash to the partners.

7. **Prepare partnership financial statements.** Partnership *financial statements* are similar to those of a proprietorship. However, the partnership income statement commonly reports the allocation of net income to the partners, and the balance sheet has a Capital account for each partner.

Self-Study Questions

Test your understanding of the chapter by marking the correct answer for each of the following questions:

1. Which of these characteristics does not apply to a partnership? *(p. 658)*
   a. Unlimited life
   b. Mutual agency
   c. Unlimited liability
   d. No income tax paid by the business entity

2. A partnership records a partner's investment of assets in the business at *(p. 660)*
   a. The partner's book value of the assets invested
   b. The market value of the assets invested
   c. A special value set by the partners
   d. Any of the above, depending upon the partnership agreement

3. The partnership of O'Connor, LaPlante, and Egly divides profits in the ratio of 4:5:3. During 2006, the business earned $40,000. Egly's share of this income is *(p. 663)*
   a. $10,000
   b. $13,333
   c. $16,000
   d. $16,667

4. Suppose the partnership of O'Connor, LaPlante, and Egly in the preceding question lost $40,000 during 2006. LaPlante 's share of this loss is *(p. 663)*
   a. Not determinable because the ratio applies only to profits
   b. $13,333
   c. $16,000
   d. $16,667

5. The partners of Fraser, Booth, and Craig share profits and losses 1/5, 1/6, and 19/30. During 2007, the first year of their partnership, the business earned $120,000, and each partner withdrew $50,000 for personal use. What is the balance in Craig's capital account after all closing entries? *(pp. 663–664)*
   a. Not determinable because Craig's beginning capital balance is not given
   b. Minus $10,000
   c. $26,000
   d. $70,000

6. Barbara Miller buys into the partnership of Quantz and Goodwin by purchasing a one-third interest for $55,000. Prior to Miller's entry, Edward Quantz's capital balance was $46,000, and Louisa Goodwin's balance was $52,000; profits and losses were shared equally. The entry to record Miller's buying into the business is *(pp. 668–669)*

a.	Cash	55,000	
	Barbara Miller, Capital		55,000
b.	Edward Quantz, Capital	27,500	
	Louisa Goodwin, Capital	27,500	
	Barbara Miller, Capital		55,000
c.	Cash	55,000	
	Barbara Miller, Capital		51,000
	Edward Quantz, Capital		2,000
	Louisa Goodwin, Capital		2,000
d.	Cash	51,000	
	Edward Quantz, Capital	2,000	
	Louisa Goodwin, Capital	2,000	
	Barbara Miller, Capital		55,000

7. The partners of Tsui, Valik, and Wollenberg share profits and losses equally. Their capital balances are $40,000, $50,000, and $60,000, respectively, when Brenda Wollenberg sells her interest in the partnership to Brent Valik for $90,000. Raymond Tsui and Valik continue the business. Immediately after Wollenberg's retirement, the total assets of the partnership are *(pp. 667–668)*
   a. Increased by $30,000
   b. Increased by $90,000
   c. Decreased by $60,000
   d. The same as before Wollenberg sold her interest to Valik

8. Prior to Bill Hogg's withdrawal from the partnership of Hogg, Ho, and Lee, the partners' capital balances were $140,000, $110,000 and $250,000 respectively. The partners share profits and losses 1/3, 1/4, and 5/12. The appraisal indicates that assets should be written down by $36,000. Arthur Ho's share of the write-down is *(p. 672–673)*
   a. $7,920
   b. $9,000
   c. $12,000
   d. $18,000

9. The process of closing the business, selling the assets, paying the liabilities, and disbursing remaining cash to the owners is called *(pp. 673–674)*
   a. Dissolution
   b. Forming a new partnership
   c. Withdrawal
   d. Liquidation

10. Rick Butterworth and Pamela Combs have shared profits and losses equally. Immediately prior to the final cash disbursement in a liquidation of their partnership, the books show:

Cash	=	Liabilities	+	Rick Butterworth, Capital	+	Pamela Combs, Capital
$100,000		$-0-		$60,000		$40,000

How much cash should Butterworth receive? *(pp. 674–675)*

a. $40,000
b. $50,000
c. $60,000
d. None of the above

Answers to the Self-Study Questions follow the Similar Accounting Terms.

Accounting Vocabulary

Dissolution *(p. 658)*
General partnership *(p. 659)*
Limited partnership *(p. 659)*
Limited liability partnership *(p. 660)*
Liquidation *(p. 673)*
Mutual agency *(p. 658)*
Partnership *(p. 656)*
Partnership agreement *(p. 657)*
Unlimited personal liability *(p. 658)*

Similar Accounting Terms

Limited Liability Partnership	LLP
Liquidation	Winding up the business
Owner's equity	Capital
Withdrawals	Drawings

Answers to Self-Study Questions

1. a
2. b
3. a ($40,000 × 3/12 = $10,000)
4. d ($40,000 × 5/12 = $16,667)
5. a
6. c [($46,000 + $52,000 + $55,000) × 1/3 = $51,000; $55,000 – $51,000 = $4,000; $4,000 ÷ 2 = $2,000 each to Quantz and Goodwin]
7. d
8. b ($36,000 × 1/4 = $9,000)
9. d
10. c

Assignment Material

Questions

1. List eight items that the partnership agreement should specify.
2. Ron Montgomery, who is a partner in M&N Associates, commits the firm to a contract for a job within the scope of its regular business operations. What term describes Montgomery's ability to obligate the partnership?
3. If a partnership cannot pay a debt, who must make payment? What term describes this obligation of the partners?
4. How is income of a partnership taxed?
5. Identify the advantages and disadvantages of the partnership form of business organization.
6. Robin Randall and Sylvia Smith's partnership agreement states that Randall gets 60 percent of profits and Smith gets 40 percent. If the agreement does not discuss the treatment of losses, how are losses shared? How do the partners share profits and losses if the agreement specifies no profit-and-loss-sharing ratio?
7. What determines the amount of the credit to a partner's Capital account when the partner contributes assets other than cash to the business?
8. Do partner withdrawals of cash for personal use affect the sharing of profits and losses by the partner? If so, explain how. If not, explain why not.
9. Name two events that can cause the dissolution of a partnership.
10. Briefly describe how to account for the purchase of an existing partner's interest in the business.
11. Jeff Malcolm purchases Sheila Wilson's interest in the Wilson & Kareem partnership. What right does Malcolm obtain from the purchase? What is required for Malcolm to become Paula Kareem's partner?
12. Sal Assissi and Barb Carter each have capital of $150,000 in their business. They share profits in the

ratio of 55:45. Kathy Denman acquires a one-fifth share in the partnership by investing cash of $100,000. What are the capital balances of the three partners immediately after Denman is admitted?

13. When a partner resigns from the partnership and receives assets greater than her or his capital balance, how is the difference shared by the other partners?
14. Distinguish between dissolution and liquidation of a partnership.
15. Name the three steps in liquidating a partnership.
16. The partnership of Ralls and Sauls is in the process of liquidation. How do the partners share (a) gains and losses on the sale of noncash assets, and (b) the final cash disbursement?
17. Compare and contrast the financial statements of a proprietorship and a partnership.
18. Summarize the situations in which partnership allocations are based on (a) the profit-and-loss ratio, and (b) the partners' capital balances.

Exercises

Exercise 12-1 *Partnership characteristics* ***(Obj. 1)***

Amy Dong and Cecillia Ewert are forming a business to imprint T-shirts. Dong suggests that they organize as a partnership in order to avoid the unlimited liability of a proprietorship. According to Dong, partnerships are not very risky.

Dong explains to Ewert that if the business does not succeed, each partner can withdraw from the business, taking the same assets that she or he invested at its beginning. Dong states that the main disadvantage of the partnership form of organization is double taxation: First, the partnership pays a business income tax; second, each partner also pays personal income tax on her or his share of the business's profits.

Correct the errors in Dong's explanation.

Exercise 12-2 *Organizing a business as a partnership* ***(Obj. 1)***

John Grant, a friend from college, approaches you about forming a partnership to export software. Since graduation, John has worked for the World Bank, developing important contacts among government officials and business leaders in Poland and Hungary. John believes he is in a unique position to capitalize on expanding markets. With your expertise in finance, you would have responsibility for accounting and finance in the partnership.

Required

Discuss the advantages and disadvantages of organizing the export business as a partnership rather than a proprietorship. Comment on the way partnership income is taxed.

Exercise 12-3 *A partner's investment in a partnership* ***(Obj. 2)***

Sage Aaron invests a building in a partnership with Catherine Adams. Aaron purchased the building for $1,200,000. Accumulated amortization on the date of forming the partnership is $320,000. A real estate appraiser states that the building is now worth $1,600,000. Aaron wants $1,600,000 capital in the new partnership, but Adams objects. Adams believes that Aaron's capital contribution into the partnership should be measured by the book value of his building.

Adams and Aaron seek your advice. Which value of the building is appropriate for measuring Aaron's capital—book value or current market value? State the reason for your answer. Give the partnership's journal entry to record Aaron's investment in the business.

Exercise 12-4 *Investments by partners* ***(Obj. 2)***

Joy Alexander and Joan Cap are forming a partnership to develop an amusement park near Toronto. Alexander contributes cash of $2 million and land valued at

$30 million. When Alexander purchased the land, its cost was $8 million. The partnership will assume Alexander's $3 million note payable on the land. Cap invests cash of $10 million and construction equipment that she purchased for $7 million (accumulated amortization to date, $3 million). The equipment's market value is equal to its book value.

Required

1. Before recording any journal entries, compute the partnership's total assets, total liabilities, and total owners' equity immediately after organizing.
2. Journalize the partnership's receipt of assets and liabilities from Alexander and from Cap. Record each asset at its current market value with no entry to accumulated amortization.
3. Use your journal entries to prove the correctness of total owners' equity from requirement 1.

Exercise 12-5 *Recording a partner's investment* ***(Obj. 2)***

Janet Almond has operated a management consulting business as a proprietorship. She and Teresa Griffiths have decided to reorganize the business as a partnership, effective April 1. Almond's investment in the partnership consists of cash, $40,000; accounts receivable, $22,000 less allowance for uncollectibles, $2,000; office furniture, $6,000 less accumulated amortization, $2,000; a small building, $110,000 less accumulated amortization, $55,000; accounts payable, $8,000; and a note payable to the bank, $20,000.

To determine Almond's equity in the partnership, she and Griffiths hire an independent appraiser. This outside party provides the following market values of the assets and liabilities that Almond is contributing to the business: cash, accounts receivable, office furniture, accounts payable, and note payable—the same as Almond's book value; allowance for uncollectible accounts, $6,000; building, $142,000; and accrued expenses payable (including interest on the note payable), $2,000.

Required

Make the entry on the partnership books to record Almond's investment.



Media Companion CD-ROM

Exercise 12-6 *Computing partners' shares of net income and net loss* ***(Obj. 3)***

Ken Davies and Jim Wiseman form a partnership, investing $40,000 and $70,000 respectively. Determine their shares of net income or net loss for each of the following situations:

a. Net loss is $52,000, and the partners have no written partnership agreement.

b. Net income is $44,000, and the partnership agreement states that the partners share profits and losses based on their capital investments.

c. Net loss is $77,000, and the partnership agreement states that the partners share profits based on their capital investments.

d. Net income is $110,000. The first $60,000 is shared based on the partner capital investments. The next $45,000 is based on partner service, with Davies receiving 30 percent and Wiseman receiving 70 percent. The remainder is shared equally.

Exercise 12-7 *Computing partners' capital balances* ***(Obj. 3)***

Ken Davies withdrew cash of $62,000 for personal use, and Jim Wiseman withdrew cash of $50,000 during the year. Using the data from situation (d) in Exercise 12-6, journalize the entries to close to each capital account the (a) income summary account, and (b) the partners' withdrawal accounts. Explanations are not required. Indicate the amount of increase or decrease in each partner's capital balance. What was the overall effect on partnership capital?

Exercise 12-8 *Admitting a new partner* ***(Obj. 4)***

Joanna Wong is admitted to a partnership. Prior to the admission of Wong, the partnership books show Tanya Ward's capital balance at $300,000 and Alan Bates's capital balance at $150,000. Ward and Bates share profits and losses equally. Compute the amount of each partner's equity on the books of the new partnership under each of the following plans:

a. Wong purchases Bates's interest in the business, paying $180,000. The $180,000 payment is not invested in the partnership but instead goes directly to Bates.
b. Wong invests $150,000 to acquire a one-fourth interest in the partnership.
c. Wong invests $270,000 to acquire a one-fourth interest in the partnership.

Exercise 12-9 *Recording the admission of a new partner* ***(Obj. 4)***

Make the partnership journal entry to record the admission of Wong under plans a, b, and c in Exercise 12-8. Explanations are not required.

Exercise 12-10 *Withdrawal of a partner from a business* ***(Obj. 5)***

After closing the books, Hurley & Rai's partnership balance sheet reports owner's equity of $72,000 for Hurley and $96,000 for Rai. Hurley is withdrawing from the firm. He and Rai agree to write down partnership assets by $36,000. They have shared profits and losses in the ratio of one-third to Hurley and two-thirds to Rai. If the partnership agreement states that a partner withdrawing from the firm will receive assets equal to the book value of his owner's equity, how much will Hurley receive? (a)

Rai will continue to operate the business as a proprietorship. What is Rai's beginning capital on the proprietorship books? (b)

Exercise 12-11 *Withdrawal of a partner* ***(Obj. 5)***

Lana Brown is retiring from the partnership of Brown, Green, and White on May 31. The partner capital balances are Brown, $36,000; Green, $51,000; and White, $22,000. The partners agree to have the partnership assets revalued to current market values. The independent appraiser reports that the book value of the inventory should be decreased by $8,000, and the book value of the land should be increased by $32,000. The partners agree to these revaluations. The profit-and-loss ratio has been 5:3:2 for Brown, Green, and White, respectively. In retiring from the firm, Brown received $25,000 cash and a $25,000 note from the partnership.

Required

Journalize (a) the asset revaluations, and (b) Brown's withdrawal from the firm.

Exercise 12-12 *Liquidation of a partnership* ***(Obj. 6)***

Leary, Tse, and Mayer are liquidating their partnership. Before selling the noncash assets and paying the liabilities, the capital balances are Leary, $50,000; Tse, $30,000; and Mayer, $20,000. The partnership agreement divides profits and losses equally.

Required

1. After selling the noncash assets and paying the liabilities, suppose the partnership has cash of $100,000. How much cash will each partner receive in final liquidation?
2. After selling the noncash assets and paying the liabilities, suppose the partnership has cash of $88,000. How much cash will each partner receive in final liquidation?

Exercise 12-13 *Liquidation of a partnership* ***(Obj. 6)***

Prior to liquidation, the accounting records of Quinn, Watt, and Basi included the following balances and profit-and-loss-sharing percentages:

				Capital		
	Cash +	Noncash Assets =	Liabilities +	Quinn (40%) +	Watt (30%) +	Basi (30%)
Balances before sale of assets	$20,000	$114,000	$42,000	$40,000	$30,000	$22,000

The partnership sold the noncash assets for $146,000, paid the liabilities, and disbursed the remaining cash to the partners. Complete the summary of transactions in the liquidation of the partnership. Use the format illustrated in Exhibit 12-4.

Exercise 12-14 *Liquidation of a partnership* ***(Obj. 6)***

The partnership of Evans, LeMare, and Beatty is dissolving. Business assets, liabilities, and partners' capital balances prior to dissolution follow. The partners share profits and losses as follows: Brian Evans, 25 percent; Cathy LeMare, 55 percent; and Jim Beatty, 20 percent.

Required

Create a spreadsheet or solve manually—as directed by your instructor—to show the ending balances in all accounts after the noncash assets are sold for $136,000 and for $90,000. Determine the unknown amounts, represented by (?):

	A	B	C	D	E	F
1			Evans, LeMare, and Beatty			
2			Sale of Noncash Assets			
3			(For $136,000)			
4				Brian	Cathy	Jim
5		Noncash		Evans,	LeMare,	Beatty,
6	Cash	Assets	Liabilities	Capital	Capital	Capital
7						
8	$ 6,000	$126,000	$77,000	$12,000	$37,000	$6,000
9	136,000	(126,000)		? †	?	?
10						
11	$142,000	$ 0	$77,000	$?	$?	$?
12						
13						† (\$A9 – \$B8)*.25
14			(For $90,000)			
15						
16				Brian	Cathy	Jim
17		Noncash		Evans,	LeMare,	Beatty,
18	Cash	Assets	Liabilities	Capital	Capital	Capital
19						
20	$ 6,000	$126,000	$77,000	$12,000	$37,000	$6,000
21	90,000	(126,000)		? **	?	?
22						
23	$96,000	$ 0	$77,000	$?	$?	$?
24						
						** (\$A21 – \$B20)*.25

Identify two ways the partners can deal with the negative ending balance in Beatty's capital account.

Challenge Exercise

Exercise 12-15 *Preparing a partnership balance sheet* ***(Obj. 7)***

On October 31, 2006, Sharon Doan and Martyn Brown agree to combine their proprietorships as a partnership. Their balance sheets on October 31 are as follows:

	Doan's Business		Brown's Business	
Assets	***Book Value***	***Current Market Value***	***Book Value***	***Current Market Value***
Cash	$ 12,000	$ 12,000	$ 10,000	$ 10,000
Accounts receivable (net)	44,000	40,000	16,000	14,000
Inventory	102,000	92,000	68,000	72,000
Capital assets (net)	244,000	210,000	108,000	120,000
Total assets	$402,000	$354,000	$202,000	$216,000
Liabilities and Capital				
Accounts payable	$ 48,000	$ 48,000	$ 20,000	$ 20,000
Accrued expenses payable	4,000	4,000	4,000	4,000
Notes payable	110,000	110,000		
Sharon Doan, capital	240,000	192,000		
Martyn Brown, capital			178,000	192,000
Total liabilities and capital	$402,000	$354,000	$202,000	$216,000

Required

Prepare the partnership balance sheet at October 31, 2006.

Beyond the Numbers

Beyond the Numbers 12–1 *Partnership issues* ***(Obj. 1, 5)***

The following questions relate to issues faced by partnerships.

1. The text suggests that a written partnership agreement may be drawn up between the partners in a partnership. One benefit of an agreement is that it provides a mechanism for resolving disputes between the partners. What are five areas of dispute that might be resolved by a partnership agreement?
2. The statement has been made that "If you must take on a partner, make sure the partner is richer than you are." Why is this statement valid?
3. Desaulles, Howard & James is a partnership of lawyers. Howard is planning to move to Australia. What are the options open to her to convert her share of the partnership assets to cash?

Ethical Issue

Gail LaRue and Cindy Ng operate The Party Centre, a party supply store in Red Deer, Alberta. The partners split profits and losses equally, and each takes an annual withdrawal of $80,000. To even out the workload, Ng does the buying and LaRue serves as the accountant. From time to time, they use small amounts of store merchandise for personal use. In preparing for a large private party, LaRue took engraved invitations, napkins, place mats, and other goods that cost $2,000. She recorded the transaction as follows:

Cost of Goods Sold	$2,000	
Inventory		$2,000

Required

1. How should LaRue have recorded this transaction?
2. Discuss the ethical dimension of LaRue's action.

Problems (Group A)

Problem 12-1A *Writing a partnership agreement* ***(Obj. 1)***

Mary Basdeo and Sue Keim are discussing the formation of a partnership to install payroll accounting systems. Basdeo is skilled in systems design, and she is convinced that her designs will draw large sales volumes. Keim is an excellent salesperson, and she has already lined up several clients.

Required

Write a partnership agreement to cover all elements essential for the business to operate smoothly. Make up amounts, profit-and-loss-sharing percentages, and so on, as needed.

Problem 12-2A *Investments by partners* ***(Obj. 2, 7)***

On June 30, 2006, Richard Bavaria and Ron Cole formed a partnership. The partners agreed to invest equal amounts of capital. Cole invested his proprietorship's assets and liabilities (credit balances in parentheses).

On June 30, 2006, Bavaria invested cash in an amount equal to the current market value of Cole's partnership capital. The partners decided that Cole would earn two-thirds of partnership profits because he would manage the business. Bavaria agreed to accept one-third of profits. During the remainder of the year, the partnership earned $210,000. Cole's withdrawals were $80,000, and Bavaria's withdrawals were $60,000.

	Cole's Book Value	Current Market Value
Accounts receivable	$16,000	$16,000
Allowance for doubtful accounts	(-0-)	(2,000)
Inventory	44,000	48,000
Prepaid expenses	4,000	4,000
Office equipment	92,000	56,000
Accumulated amortization—office equipment	(32,000)	(-0-)
Accounts payable	(40,000)	(40,000)

Required

1. Journalize the partners' initial investments.
2. Prepare the partnership balance sheet immediately after its formation on June 30, 2006.
3. Journalize the December 31, 2006, entries to close the Income Summary account and the partners' withdrawals accounts.

Problem 12-3A *Admitting a new partner* ***(Obj. 4)***

Oakridge Consulting Associates is a partnership, and its owners are considering admitting Helen Oldham as a new partner. On March 31, 2006, the capital accounts of the three existing partners and their shares of profits and losses are as follows:

	Capital	Profit-and-Loss Ratio
Jim Zook	$ 40,000	15%
Richard Land	100,000	30%
Jennifer Lim	160,000	55%

Required

Journalize the admission of Oldham as a partner on March 31, 2006, for each of the following independent situations:

1. Oldham pays Lim $145,000 cash to purchase Lim's interest in the partnership.
2. Oldham invests $60,000 in the partnership, acquiring a one-sixth interest in the business.
3. Oldham invests $60,000 in the partnership, acquiring a one-fifth interest in the business.
4. Oldham invests $40,000 in the partnership, acquiring a 10 percent interest in the business.

Problem 12-4A *Computing partners' shares of net income and net loss* ***(Obj. 3, 7)***



Alfred Folk, Bev Gutray, and Robert Virk have formed a partnership. Folk invested $15,000, Gutray $18,000, and Virk $27,000. Folk will manage the store, Gutray will work in the store half time, and Virk will not work in the business.

Required

1. Compute the partners' shares of profits and losses under each of the following plans:
   a. Net loss is $42,900, and the partnership agreement does not specify how profits and losses are shared.
   b. Net loss is $60,000, and the partnership agreement allocates 40 percent of profits to Folk, 25 percent to Gutray, and 35 percent to Virk. The agreement does not discuss the sharing of losses.
   c. Net income is $92,000. The first $40,000 is allocated based on "salaries," with Folk receiving $28,000 and Gutray receiving $12,000. The remainder is allocated based on partner capital investments.
   d. Net income for the year is $180,000. The first $80,000 is allocated based on partner capital investments. The next $36,000 is based on service, with Folk receiving $28,000 and Gutray receiving $8,000. Any remainder is shared equally.
2. Revenues for the year were $870,000 and expenses were $690,000. Under plan (d), prepare the partnership income statement for the year. Assume a January 31, 2006 year end.
3. How will what you learned in this problem help you manage a partnership?

Problem 12-5A *Recording changes in partnership capital* ***(Obj. 4, 5)***

Vector Financial Planning is a partnership owned by three individuals. The partners share profits and losses in the ratio of 28 percent to Katherine Smythe, 38 percent to Max Dune, and 34 percent to Emily Hahn. At December 31, 2006, the firm has the following balance sheet:

Cash		$ 36,000	Total liabilities	$195,000
Accounts receivable	$66,000			
Less: Allowance for uncollectibles	12,000	54,000	Katherine Smythe, capital	279,000
Building	$930,000		Max Dune, capital	150,000
Less: Accumulated amortization	210,000	720,000	Emily Hahn, capital	186,000
Total assets		$810,000	Total liabilities and capital	$810,000

Dune withdraws from the partnership on December 31, 2006, to establish his own consulting practice.

Required

Record Dune's withdrawal from the partnership under the following plans:

1. Dune gives his interest in the business to Tony Dutoit, his nephew, with the consent of Smythe and Hahn.
2. In personal transactions, Dune sells his equity in the partnership to Bea Patell and Al Bruckner, who each pay Dune $150,000 for one-half of his interest. Smythe and Hahn agree to accept Patell and Bruckner as partners.
3. The partnership pays Dune cash of $45,000, and gives him a note payable for the remainder of his book equity in settlement of his partnership interest.
4. Dune receives cash of $30,000 and a note for $210,000 from the partnership.
5. The partners agree that the building is worth $630,000 (net). After the revaluation, the partnership settles with Dune by giving him cash of $30,000 and a note payable for the remainder of his book equity.

Problem 12-6A *Liquidation of a partnership* ***(Obj. 6)***

The partnership of Amping, Blair, and Trippi has experienced operating losses for three consecutive years. The partners, who have shared profits and losses in the ratio of Denise Amping, 10 percent, Bert Blair, 30 percent, and Toni Trippi, 60 percent, are considering the liquidation of the business. They ask you to analyze the effects of liquidation under various possibilities about the sale of the noncash assets. They present the following condensed partnership balance sheet at December 31, 2005:

Cash	$ 27,000	Liabilities	$121,000
Noncash assets	202,000	Denise Amping, capital	31,000
		Bert Blair, capital	39,000
		Toni Trippi, capital	38,000
Total assets	$229,000	Total liabilities and capital	$229,000

Required

1. Prepare a summary of liquidation transactions (as illustrated in the chapter) for each of the following situations:
   a. The noncash assets are sold for $212,000.
   b. The noncash assets are sold for $172,000.
2. Make the journal entries to record the liquidation transactions in Requirement 1(b).

Problem 12-7A *Liquidation of a partnership* ***(Obj. 6)***

Link Back to Chapter 4 (Closing Entries). LD&D is a partnership owned by T. Longair, D. Douglas, and J. Duncan, who share profits and losses in the ratio of 5:3:2. The adjusted trial balance of the partnership (in condensed form) at September 30, 2006, is on the next page.

Required

1. Prepare the September 30, 2006, entries to close the revenue, expense, income summary, and withdrawals accounts.
2. Using T-accounts, insert the opening capital balances in the partner capital accounts, post the closing entries to the capital accounts, and determine each partner's ending capital balance.
3. The partnership liquidates on September 30, 2006, by selling the noncash assets for $264,000. Using the ending balances of the partners' capital accounts, prepare a summary of liquidation transactions (as illustrated in Exhibit 12-4 on page 675).

LD&D
Adjusted Trial Balance
September 30, 2006

Cash	$100,000	
Noncash assets	354,000	
Liabilities		$290,000
T. Longair, capital		114,000
D. Douglas, capital		88,000
J. Duncan, capital		42,000
T. Longair, withdrawals	90,000	
D. Douglas, withdrawals	74,000	
J. Duncan, withdrawals	36,000	
Revenues		844,000
Expenses	724,000	
Totals	$1,378,000	$1,378,000

Problem 12-8A *Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the withdrawal of a partner; preparing partnership balance sheet* ***(Obj. 2, 3, 4, 5, 7)***

2004

June 10 Steven Dikolli and Sharon McCracken have agreed to pool their assets and form a partnership to be called D&M Distributors. They agree to share all profits equally and make the following initial investments:

	Dikolli	McCracken
Cash	$28,000	$48,000
Accounts receivable (net)	56,000	28,000
Office furniture (net)	64,000	36,000

Dec. 31 The partnership's reported net income was $304,000 for the year ended December 31, 2004.

2005

Jan. 1 Dikolli and McCracken agree to accept Myra Pinos into the partnership with a $280,000 investment for 40 percent of the business. The partnership agreement is amended to provide for the following sharing of profits and losses:

	Dikolli	McCracken	Pinos
Annual "salary"	$160,000	$120,000	$80,000
Interest on investment	10%	10%	10%
Balance in ratio of	2 :	3 :	5

Dec. 31 The partnership's reported net income is $760,000.

2006

Oct. 10 Dikolli withdrew $120,000 cash from the partnership and McCracken withdrew $80,000 (Pinos did not make any withdrawals).

May 31 The partnership's reported net income is $300,000.

2007

Jan. 2 After a disagreement as to the directions in which the partnership should be moving, Pinos decided to withdraw from the partnership. The three partners agreed that Pinos could take cash of $680,000 in exchange for her equity in the partnership.

Required

1. Journalize all of the transactions for the partnership.
2. Prepare the partners' equity section of the balance sheet as of January 2, 2007.

Problem 12-9A *Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the liquidation of a partnership* ***(Obj. 2, 3, 4, 5, 6)***

William Press, Julie Harris, and Regina Visser started a partnership to operate a courier service. The partnership (PH&V Couriers) had the following transactions:

2005

Jan. 2 Press, Harris, and Visser formed the partnership by signing an agreement that stated that all profits would be shared in a 2:3:5 ratio and by making the following investments:

	Press	Harris	Visser
Cash	$36,000	$ 24,000	$ 44,000
Accounts receivable (net)	60,000	44,000	180,000
Office furniture (net)	0	0	44,000
Vehicles (net)	64,000	116,000	0

Dec. 31 The partnership reported net income of $160,000 for the year.

2006

June 7 Press and Visser agreed that Harris could sell her share of the partnership to Ray Ewing for $248,000. The new partners agreed to keep the same profit-sharing arrangement (2:3:5 for Press:Ewing:Visser).

Dec. 31 The partnership reported a net loss of $200,000 for the year.

2007

Jan. 3 The partners agreed to liquidate the partnership. On this date the balance sheet showed the following items:

Cash	$ 52,000
Accounts receivable	948,000
Allowance for uncollectible accounts	68,000
Office furniture	224,000
Vehicles	720,000
Accumulated amortization (total)	148,000
Accounts payable	1,156,000

The assets were sold for the following amounts:

Accounts receivable	$ 572,000
Office furniture	248,000
Vehicles	320,000

Press and Ewing both have personal assets, but Visser does not.

Required

Journalize all of the transactions for the partnership.

Problems (Group B)

Problem 12-1B *Writing a partnership agreement* ***(Obj. 1)***

Lupita Mendez and Holly French are discussing the formation of a partnership to import fabric. Mendez is especially artistic, so she will travel to Mexico to buy merchandise. French is an excellent salesperson, and has already lined up several large stores to sell the fabric.

Required

Write a partnership agreement to cover all elements essential for the business to operate smoothly. Make up amounts, profit-and-loss-sharing percentages, and so on as needed.

Problem 12-2B *Investments by partners* ***(Obj. 2, 7)***

Jay Banks and Patti Martin formed a partnership on March 15, 2006. The partners agreed to invest equal amounts of capital. Banks invested his proprietorship's assets and liabilities (credit balances in parentheses):

	Banks's Book Value	Current Market Value
Accounts receivable	$ 24,000	$24,000
Allowance for doubtful accounts	(2,000)	(3,000)
Inventory	88,000	62,000
Prepaid expenses	5,000	5,000
Store equipment	74,000	54,000
Accumulated amortization	(20,000)	(-0-)
Accounts payable	(44,000)	(44,000)

On March 15, Martin invested cash in an amount equal to the current market value of Banks's partnership capital. The partners decided that Banks would earn 70 percent of partnership profits because he would manage the business. Martin agreed to accept 30 percent of profits. During the period ended December 31, 2006, the partnership earned $180,000. Martin's withdrawals were $64,000 and Banks's withdrawals were $72,000.

Required

1. Journalize the partners' initial investments.
2. Prepare the partnership balance sheet immediately after its formation on March 15, 2006.
3. Journalize the December 31, 2006, entries to close the Income Summary account and the partner withdrawals accounts.

Problem 12-3B *Admitting a new partner* ***(Obj. 4)***

Hidden Valley Resort is a partnership, and its owners are considering admitting Benjamin Tal as a new partner. On July 31, 2006, the capital accounts of the three existing partners and their shares of profits and losses are as follows:

	Capital	Profit-and-Loss Ratio
Eleanor Clitheroe	$36,000	1/6
Amy Osler	48,000	1/3
Brian Harcourt	66,000	1/2

Required

Journalize the admission of Tal as a partner on July 31, 2006, for each of the following independent situations.

1. Tal pays Harcourt $37,500 cash to purchase one-half of Harcourt's interest.
2. Tal invests $37,500 in the partnership, acquiring a one-fifth interest in the business.
3. Tal invests $30,000 in the partnership, acquiring a one-eighth interest in the business.
4. Tal invests $22,500 in the partnership, acquiring a 15 percent interest in the business.

Problem 12-4B *Computing partners' shares of net income and net loss* ***(Obj. 3, 7)***



Media Companion CD-ROM

Colleen Rogers, Karen Sharp, and Jim Nesbitt have formed a partnership. Rogers invested $20,000, Sharp $40,000, and Nesbitt $60,000. Rogers will manage the store, Sharp will work in the store three-quarters of the time, and Nesbitt will not work in the business.

Required

1. Compute the partners' shares of profits and losses under each of the following plans:
   a. Net income is $87,000, and the partnership agreement does not specify how profits and losses are shared.
   b. Net loss is $47,000, and the partnership agreement allocates 45 percent of profits to Rogers, 35 percent to Sharp, and 20 percent to Nesbitt. The agreement does not discuss the sharing of losses.
   c. Net income is $104,000. The first $50,000 is allocated based on "salaries" of $34,000 for Rogers and $16,000 for Sharp. The remainder is allocated based on partners' capital investments.
   d. Net income for the year is $91,000. The first $30,000 is allocated on the basis of partners' capital investments. The next $30,000 is based on service, with $20,000 going to Rogers and $10,000 going to Sharp. Any remainder is shared equally.
2. Revenues for the year were $572,000 and expenses were $481,000. Under plan (d), prepare the partnership income statement for the year. Assume a year end of September 30, 2006.
3. How will what you have learned in this problem help you manage a partnership?

Problem 12-5B *Recording changes in partnership capital* ***(Obj. 4, 5)***

BackCountry Equipment is a partnership owned by three individuals. The partners share profits and losses in the ratio of 30 percent to Karen Tennent, 40 percent to Frank Dunn, and 30 percent to Erin Hanafy. At December 31, 2005, the firm has the following balance sheet:

Cash		$ 70,000	Total liabilities	$236,000
Accounts receivable	$ 40,000			
Less: Allowance for uncollectibles	2,000	38,000		
Inventory		196,000	Karen Tennent, capital	90,000
Equipment	300,000		Frank Dunn, capital	118,000
Less: Accumulated amortization	60,000	240,000	Erin Hanafy, capital	100,000
Total assets		$544,000	Total liabilities and capital	$544,000

Karen Tennent withdraws from the partnership on this date.

Required

Record Tennent's withdrawal from the partnership under the following plans:

1. Tennent gives her interest in the business to Lynn Jones, her cousin, with the consent of Dunn and Hanafy.
2. In personal transactions, Tennent sells her equity in the partnership to Michael Adams and Craig Thomas, who each pay Tennent $40,000 for one-half of her interest. Dunn and Hanafy agree to accept Adams and Thomas as partners.
3. The partnership pays Tennent cash of $10,000, and gives her a note payable for the remainder of her book equity in settlement of her partnership interest.
4. Tennent receives cash of $40,000 and a note for $60,000 from the partnership.
5. The partners agree that the equipment is worth $340,000 (net). After the revaluation, the partnership settles with Tennent by giving her cash of $20,000 and inventory for the remainder of her book equity.

Problem 12-6B *Liquidation of a partnership* ***(Obj. 6)***

The partnership of Chan, Nixon & Galloway has experienced operating losses for three consecutive years. The partners, who have shared profits and losses in the ratio of Lisa Chan, 15 percent, John Nixon, 60 percent, and Brian Galloway, 25 percent, are considering the liquidation of the business. They ask you to analyze the effects of liquidation under various assumptions about the sale of the noncash assets. They present the following condensed partnership balance sheet at December 31, 2005:

Cash	$ 68,000	Liabilities	$252,000
Noncash assets	612,000	Lisa Chan, capital	96,000
		John Nixon, capital	264,000
		Brian Galloway, capital	68,000
		Total liabilities	
Total assets	$680,000	and capital	$680,000

Required

1. Prepare a summary of liquidation transactions (as illustrated in the chapter) for each of the following situations:
   a. The noncash assets are sold for $700,000.
   b. The noncash assets are sold for $564,000.
2. Make the journal entries to record the liquidation transactions in requirement 1(b).

Problem 12-7B *Liquidation of a partnership* ***(Obj. 6)***

Link Back to Chapter 4 (Closing Entries). AFS & Company is a partnership owned by K. Allen, R. Flowers, and B. Saylor, who share profits and losses in the ratio of 1:3:4. The adjusted trial balance of the partnership (in condensed form) at June 30, 2006, is shown below.

Required

1. Prepare the June 30, 2006, entries to close the revenue, expense, income summary, and withdrawals accounts.
2. Using T-accounts, insert the opening capital balances in the partners' capital accounts, post the closing entries to the capital accounts, and determine each partner's ending capital balance.
3. The partnership liquidates on June 30, 2006, by selling the noncash assets for $300,000. Using the ending balances of the partners' capital accounts, prepare a summary of liquidation transactions (as illustrated in Exhibit 12-4 on page 675).

AFS & COMPANY
Adjusted Trial Balance
June 30, 2006

Cash	$ 72,000	
Noncash assets	348,000	
Liabilities		$300,000
K. Allen, capital		66,000
R. Flowers, capital		123,000
B. Saylor, capital		186,000
K. Allen, withdrawals	42,000	
R. Flowers, withdrawals	105,000	
B. Saylor, withdrawals	162,000	
Revenues		324,000
Expenses	270,000	
Totals	$999,000	$999,000

Problem 12-8B *Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the withdrawal of a partner; preparing a partnership balance sheet* ***(Obj. 2, 3, 4, 5, 7)***

2004

June 10 Amie Dhal and Marie Sung have agreed to pool their assets and form a partnership to be called D&S Consulting. They agree to share all profits equally and make the following initial investments:

	Dhal	Sung
Cash	$20,000	$40,000
Accounts receivable (net)	44,000	36,000
Office furniture	48,000	32,000

Dec. 31 The partnership's reported net income was $260,000 for the year ended December 31, 2004.

2005

Jan. 1 Dhal and Sung agree to accept Mark Mason into the partnership with a $240,000 investment for 30 percent of the business. The partnership agreement is amended to provide for the following sharing of profits and losses:

	Dhal	Sung	Mason
Annual "salary"	$120,000	$160,000	$100,000
Interest on investment	10%	10%	10%
Balance in ratio of	3 :	2 :	5

Dec. 31 The partnership's reported net income was $640,000.

2006

Oct. 10 Dhal withdrew $112,000 cash from the partnership and Sung withdrew $76,000 (Mason did not make any withdrawals).

Dec. 31 The partnership's reported net income was $340,000.

2007

Jan. 2 After a disagreement as to the directions in which the partnership should be moving, Mason decided to withdraw from the partnership. The three partners agreed that Mason could take cash of $400,000 in exchange for his equity in the partnership.

Required

1. Journalize all of the transactions for the partnership.
2. Prepare the partners' equity section of the balance sheet as of January 2, 2007.

Problem 12-9B *Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the liquidation of a partnership* ***(Obj. 2, 3, 4, 5, 6)***

Judy Chapin, Herb Nobes, and Jean Yee started a partnership to operate a management consulting business. The partnership (CNY Partners) had the following transactions:

2005

Jan. 2 Chapin, Nobes, and Yee formed the partnership by signing an agreement that stated that all profits would be shared in a 3:2:5 ratio and by making the following investments:

	Chapin	Nobes	Yee
Cash	$ 4,000	$ 7,000	$23,000
Accounts receivable (net)	14,000	21,000	30,000
Office furniture	0	11,000	0
Computer equipment	26,000	0	9,000

Dec. 31 The partnership reported net income of $42,000 for the year.

2006

June 7 Chapin and Yee agreed that Nobes could sell his share of the partnership to André Dawson for $62,000. The new partners agreed to keep the same profit-sharing arrangement (3:2:5 for Chapin:Dawson:Yee).

Dec. 31 The partnership reported a net loss of $50,000 for the year.

2007

Jan. 3 The partners agreed to liquidate the partnership. On this date the balance sheet showed the following items:

Cash	$ 13,000
Accounts receivable	246,000
Allowance for uncollectible accounts	12,000
Office furniture	60,000
Computer equipment	150,000
Accumulated amortization (total)	46,000
Accounts payable	274,000

The assets were sold for the following amounts:

Accounts receivable	$120,000
Office furniture	65,000
Computer equipment	90,000

Chapin and Dawson both have personal assets, but Yee does not.

Required

Journalize all of the transactions for the partnership.

Challenge Problems

Problem 12-1C *Deciding on a capital structure* ***(Obj. 1, 2)***

Rebecca Bernstein and Peter Tong have been in a partnership for five years. The principal business of the partnership is systems design for financial institutions. Gross revenues have increased from $82,000 in 2002 to $935,000 in 2006, the year just ended. The number of employees has increased from two in the first year to nine in the most recent year. Bernstein and Tong realized that they had to build up the partnership's capital and have withdrawn only part of the annual profits. As a result, their capital accounts have increased from $50,000 (Bernstein, $35,000; Tong, $15,000) in 2002 to $520,000 (Bernstein, $280,000; Tong, $240,000) in 2006.

The two partners realize that they must expand their capital base to expand their operations in order to meet the increasing demand for their systems designs. At the same time they wish to take personal advantage of the partnership's earnings. They have been trying to determine whether they should continue the partnership and borrow the necessary funds, take on one or more partners (several of their employees have expressed interest and have capital to invest), or incorporate and sell a portion of the business to outsiders. With respect to incorporation, Martin Askew, a former classmate of Bernstein's who works for a stockbroker, has indicated he knows of investors who would be interested in buying a share of the business.

Required

Bernstein and Tong have come to you to ask for advice. Provide an analysis of the situation and make a recommendation. In response to your questions, they indicate they will need additional capital of $400,000 to $500,000.

Problem 12-2C *The effects of accounting decisions on profits* ***(Obj. 3)***

Mary Antoine, Susan Chiu, and Alan May have been partners in a systems design business for the past eight years. Antoine and May work full-time in the business;

Chiu has a public accounting practice and works about five to ten hours per week on the administrative side of the business. The business has been successful and the partners are considering expansion.

The partnership agreement states that profits will be distributed as follows:

1. Partners will get 6 percent on their average capital balances.
2. Antoine will get a "salary" of $75,000; Chiu will get a "salary" of $9,375; May will get a "salary" of $75,000.
3. The balance remaining will be distributed on the basis of Antoine, 40 percent; Chiu, 20 percent; and May, 40 percent.

The agreement also stipulates that the distributions outlined in parts 1 and 2 of the agreement will be made even if there are not sufficient profits and that any deficiency will be shared on the basis of part 3.

The capital structure was as follows at December 31, 2006:

Antoine	$ 168,750
Chiu	1,031,250
May	431,250
Total	$1,631,250

There has been some stress in the partnership of late because Antoine believes that she is contributing a major part of the effort but is earning much less than May; Chiu is upset because she believes that she is earning the least even though her capital is essentially funding the partnership.

Required

Mary Antoine, Susan Chiu, and Alan May have come to you to ask for advice as to how they might amicably settle the present dispute. Analyze the situation and make a recommendation. Assume net income in 2006 was $393,750.

Extending Your Knowledge

Decision Problem

Settling disagreements among partners (Obj. 3)

Barbara Jevons invested $40,000 and Tara Schlee invested $20,000 in a public relations firm that has operated for 10 years. Neither partner has made an additional investment. They have shared profits and losses in the ratio of 2:1, which is the ratio of their investments in the business. Jevons manages the office, supervises the 16 employees, and does the accounting. Schlee, the moderator of a television talk show, is responsible for marketing. Her high profile generates important revenue for the business. During the year ended December 2006, the partnership earned net income of $100,000, shared in the 2:1 ratio. On December 31, 2006, Jevons's capital balance was $210,000 and Schlee's capital balance was $140,000.

Required

Respond to each of the following situations:

1. What explains the difference between the ratio of partner capital balances at December 31, 2006, and the 2:1 ratio of partner investments and profit sharing?
2. Schlee believes the profit-and-loss-sharing ratio is unfair. She proposes a change,

but Jevons insists on keeping the 2:1 ratio. What two factors may underlie Schlee's unhappiness?

3. During January 2007, Jevons learned that revenues of $15,000 were omitted from the reported 2006 income. She brings this to Schlee's attention, pointing out that her share of this added income is two-thirds, or $10,000 and Schlee's share is one-third, or $5,000. Schlee believes they should share this added income based on their capital balances: 60 percent (or $9,000) to Jevons, and 40 percent (or $6,000) to Schlee. Which partner is correct? Why?
4. Assume that an account payable of $12,000 for an operating expense in 2006 was omitted from 2006 reported income. On what basis would the partners share this amount?

Financial Statement Problem

Fortin, Lin & Royce (FLR) is a regional accounting firm with four offices. Summary data from the partnership's annual report follow:

(Dollars in thousands, except where indicated)	Years Ended June 30				
	2006	2005	2004	2003	2002
Revenues					
Assurance services	$1,234	$1,122	$1,064	$1,093	$1,070
Consulting services	1,007	775	658	473	349
Tax services	743	628	567	515	557
Total Revenues	$2,984	$2,525	$2,289	$2,081	$1,976
Operating Summary					
Revenues	$2,984	$2,525	$2,289	$2,081	$1,976
Personnel Costs	1,215	1,004	887	805	726
Other Costs	712	630	517	458	415
Income to Partners	$1,057	$ 891	$ 885	$ 818	$ 835
Statistical Data					
Average Number of Partners	9	9	9	8	8

Required

1. What percentages of total revenues did FLR earn by performing assurance services (similar to audit), consulting services, and tax services during 2002? What were the percentages in 2006? Which type of service grew the most from 2002 to 2006?
2. Compute the average revenue per partner in 2006. Assume each partner works 2,000 hours per year. On average, how much does each partner charge a client for one hour of time?
3. How much net income did each FLR partner earn, on average, in 2006?

CHAPTER

13

Corporations: Share Capital and the Balance Sheet

CHAPTER OBJECTIVES

After studying this chapter, you should be able to

1. Identify the characteristics of a corporation
2. Record the issuance of shares
3. Prepare the shareholders' equity section of a corporation's balance sheet
4. Account for cash dividends
5. Use different share values in decision making
6. Evaluate a company's return on assets and return on shareholders' equity
7. Account for a corporation's income tax



Media Companion CD-ROM

Visit the Media Companion CD-ROM that comes with this book for extra practice with the new material in Chapter 13.

Frank Stronach launched a tool-and-die shop in Toronto. His first customer, General Motors, contracted him to make sun visor brackets. Today his company, Magna International Inc. (www.magna.com), employs 72,000 people at 201 sites in 22 countries. Sales of auto systems, assemblies, modules, and components are expected to reach $20 billion (U.S. dollars) by 2008.



Over the years, the company has sold shares of a number of its divisions to the public while retaining control of the companies. Such companies include Intier Automotive Inc., Magna Entertainment Corp., and Tesma International Inc. The sale of shares allows Magna to raise money for expansion but still keep control of the division.

Sources: *National Post Business*, September 2002, pp. 42–54; *Canadian Business*, July 7, 2003, pp. 83–84.

THIS chapter covers the issuance of shares by corporations such as Magna International Inc. A corporation that issues its shares to the general public is said to *go public*. Any company—large or small—can go public.

All companies issue shares for the same reasons: to raise money, obtain assets, or pay off debt. Now, let's explore how corporations differ from the proprietorships and partnerships we have been studying.

Corporations: An Overview

The corporation is the dominant form of business organization in Canada. Magna International Inc. is an example. Although proprietorships and partnerships are more numerous, corporations transact more business and are larger in terms of total assets, sales revenue, and number of employees. Most well-known businesses, such as The Forzani Group Ltd. (www.forzanigroup.com), the sporting goods retailer, EnCana Corp. (www.encana.com), the oil and gas producer, and The Jean Coutu Group (PJC) Inc. (www.jeancoutu.com), the drugstore chain, are corporations. Their full names include *Limited*, *Incorporated*, or *Corporation* (abbreviated *Ltd.*, *Inc.*, or *Corp.*) to indicate they are corporations.

Characteristics of a Corporation

OBJECTIVE 1
Identify the characteristics of a corporation

What makes the corporate form of organization so attractive? Several things. We now examine the features of corporations and their advantages and disadvantages.

Separate Legal Entity A corporation is a business entity formed under federal or provincial law. The federal or provincial government grants **articles of incorporation**, which consist of a document that gives the governing body's permission to form a corporation. Neither a proprietorship nor a partnership requires federal or provincial approval to do business, because in the eyes of the law the business and the owner(s) are not separate entities.

From a legal perspective, a corporation is a distinct entity, an artificial person that exists apart from its owners, who are called **shareholders**. The corporation has many of the rights that a person has. For example, a corporation may buy, own, and sell property. Assets and liabilities in the business belong to the corporation rather than to the corporation's owners. The corporation may enter into contracts, sue, and be sued just like an individual.

Continuous Life and Transferability of Ownership The owners' equity of a corporation is divided into **shares** of **stock**. The articles of incorporation specify how many shares the corporation can issue (sell) and lists the other details of its relationships with the federal or provincial government under whose laws it is incorporated. Most corporations have *continuous lives* regardless of changes in the ownership of their shares. The shareholders of Forzani or EnCana or any corporation may sell or trade the shares to another person, give them away, bequeath them in a will, or dispose of them in any other way they desire. The transfer of the shares does not affect the continuity of the corporation. In contrast, proprietorships and partnerships terminate when their ownership changes.

No Mutual Agency *Mutual agency* means that all owners act as agents of the business. A contract signed by one owner is binding for the whole company. Mutual agency operates in partnerships but *not* in corporations. A shareholder of Loblaw Companies Limited (www.loblaw.com) cannot commit the corporation to a contract (unless the shareholder is also an officer in the business).

Limited Liability of Shareholders Shareholders have **limited liability** for corporation debts. That means they have no personal obligation for corporation liabilities. The most that a shareholder can lose on an investment in a corporation's shares is the cost of the investment. In contrast, proprietors and partners are personally liable for all the debts of their businesses unless the partnership is a limited liability partnership (LLP).

REAL WORLD EXAMPLE

Because of limited shareholder liability, many banks will lend money to a small corporation only if a third party (usually a corporate officer) guarantees payment of the loan personally in the event of default by the corporation.

The combination of limited liability and no mutual agency means that persons can invest in a corporation without fear of losing all their personal wealth if the business fails. This feature enables a corporation to raise more money than proprietorships and partnerships can.

Separation of Ownership and Management Shareholders own a corporation, but a *board of directors*—elected by the shareholders—appoints corporate officers to manage the business. Shareholders may invest $100 or $1 million without having to manage the business.

KEY POINT

Corporations are owned by investors who usually are not involved in the daily operation. A corporation's financial statements should provide the information for investors and managers to make sound decisions.

Management's goal is to maximize the value of the firm for the benefit of the shareholders. The separation of shareholders and management can create problems. Corporate officers may manage the business for their own benefit and not for the shareholders. The distance between shareholders and management may make it difficult for shareholders to protest bad management. So how can shareholders protest? One way is to vote on matters that come before them. In the extreme, they can sell their shares.

Corporate Taxation Corporations are separate taxable entities. They pay a variety of taxes not borne by proprietorships or partnerships, such as federal and provincial income taxes. Corporate earnings are subject to **double taxation**. First, corporations pay their own income taxes on corporate income. Then, the shareholders pay personal income tax on the dividends (distributions) that they receive from corporations, although the tax rate is usually lower than for regular income to minimize double taxation. Proprietorships and partnerships pay no business income tax. Instead, the tax falls solely on the owners who are taxed on their share of the proprietorship or partnership income.

Government Regulation Because shareholders have only limited liability for corporation debts, outsiders doing business with the corporation can look no further than the corporation for payment of its debts. To protect persons who lend money to a corporation or who invest in its shares, the federal and provincial governments monitor the affairs of corporations. This government regulation consists mainly of ensuring that corporations disclose adequate business information for investors and creditors. This government regulation creates some expense for corporations that is not borne by proprietorships or partnerships.

Exhibit 13-1 summarizes the advantages and disadvantages of the corporation form of business organization.

EXHIBIT 13-1

Advantages and Disadvantages of a Corporation

Corporation Advantages	Corporation Disadvantages
1. Can raise more money than a proprietorship or partnership	1. Separation of ownership and management
2. Continuous life	2. Corporate earnings subject to some double taxation
3. Ease of transferring ownership	3. Government regulation
4. No mutual agency of shareholders	
5. Limited liability of shareholders	

STOP & THINK

Compare and contrast the characteristics of proprietorships and corporations.

Answer:

Proprietorship

1. Legally, the owner and the business are one entity.
2. Limited to life of proprietor.
3. Unlimited liability of the owner.
4. Management by owner.
5. Business income is included in calculating owner's taxable income.

Corporation

1. Separate legal entity.
2. Continuous life.
3. Limited liability of shareholders.
4. Often separation of ownership and management.
5. Pays corporate income tax.

Organization of a Corporation

The process of creating a corporation begins when its organizers, called the *incorporators*, submit articles of incorporation to the federal or provincial government for approval. The articles of incorporation include the **authorization (of shares)** for the corporation to issue a certain number of shares of stock, which are shares of ownership in the corporation. The incorporators pay fees and file the required documents with the incorporating jurisdiction. Then the corporation comes into existence and becomes a legal entity. The incorporators agree to a set of **bylaws**, which act as the constitution for governing the corporation.

The ultimate control of the corporation rests with the shareholders, who usually receive one vote for each voting share they own. For example, the shareholders elect the members of the **board of directors**, which sets policy for the corporation and appoints the officers. The board elects a **chairperson**, who is the most powerful person in the corporation. The board also designates the **president**, who is the chief operating officer in charge of managing day-to-day operations. Most corporations have a number of vice-presidents. Exhibit 13-2 shows the authority structure in a corporation.

All corporations have an annual meeting at which the shareholders elect directors and make other shareholder decisions such as appointing the external auditors. Shareholders unable to attend this annual meeting may vote on corporation matters by use of a *proxy*, which is a legal document that expresses the shareholder's preference and appoints another person to cast the vote.

KEY POINT

Most corporations are authorized to issue many more shares of stock than they intend to issue originally. The corporation can raise additional capital by selling shares in the future without having to request government authorization of more shares.

Share Capital

A corporation issues *share certificates* to its owners when they invest in the business. Because shares represent the corporation's capital, they are often called *share capital*.

KEY POINT

Note the differences between the following terms:

Authorized shares—the maximum number of shares the corporation can issue. This number is specified in the articles of incorporation but can be increased.

Issued and outstanding shares—shares that have been sold to shareholders and for which share certificates have been issued.

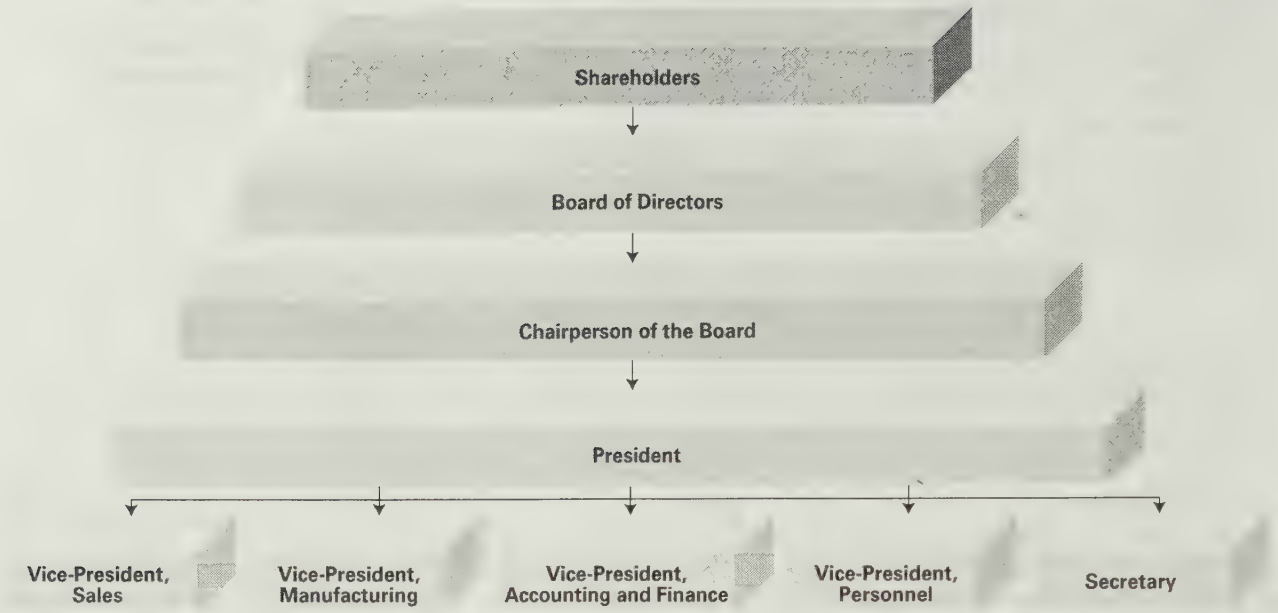


EXHIBIT 13-2

Authority Structure in a Corporation

The basic unit of share capital is called a *share*. A corporation may issue a share certificate for any number of shares it wishes—one share, 100 shares, or any other number. Exhibit 13-3 depicts an actual share certificate for 200 Intrawest Corporation shares. The certificate shows the company name, shareholder name, type of shares, and number of shares.

Shares that are held by a shareholder are said to be **outstanding**. The total number of shares outstanding at any time represents 100 percent ownership of the corporation.

EXHIBIT 13-3

Share Certificate



EXHIBIT 13-4

Summarized Shareholders' Equity at February 2, 2003, of The Forzani Group Ltd. (amounts in thousands)

Shareholders' equity	
Contributed capital	$124,866
Retained earnings	78,857
Total shareholders'equity	$203,723

Shareholders' Equity: The Basics

The balance sheet of a corporation reports assets and liabilities in the same way as a proprietorship or a partnership, but owners' equity of a corporation—called **shareholders' equity**—is reported differently. Incorporating acts require corporations to report the sources of their capital. The two most basic sources of capital are:

- **Contributed capital,** which represents investments in share capital by shareholders in the corporation.
- **Retained earnings** is capital earned by profitable operations.

While the *Canada Business Corporations Act* and several of the provincial incorporating acts use the term *stated capital* to describe share capital, this text will use the more common term, share capital. Exhibit 13-4 outlines a summarized version of the balance sheet of The Forzani Group Ltd. to show how to report these categories of shareholders' equity.

Contributed Capital Comes from the Shareholders

Common shares are one type of share capital. They are regarded as the permanent capital of the business because it is ***not*** subject to withdrawal by the shareholders. The Forzani Group Ltd.'s entry to record the receipt of $200,000 cash and the issuance of its common shares to the shareholder is

Oct.	20	Cash	200,000	
		Common Shares		200,000
		Issued shares to shareholder.		

This entry shows that issuing shares increases both the assets and the shareholders' equity of a corporation.

Retained Earnings Comes from Profitable Operations

Profitable operations produce income for the corporation, which increases shareholders' equity through a separate account called Retained Earnings.

As we have just seen, a corporation needs more capital accounts than a proprietorship. A corporation uses a Common Shares account and a Retained Earnings account. Corporations close their revenues and expenses into Income Summary, and then they close net income to Retained Earnings. To illustrate, The Forzani Group Ltd.'s revenues for the 53 weeks ended February 2, 2003, were $923,795,000 and expenses totalled $893,264,000.

The closing entries would be

2003				
Feb.	2	Revenue	923,795,000	
		Income Summary		923,795,000
		To close revenue.		
Feb.	2	Income Summary	893,264,000	
		Expenses (detailed)		893,264,000
		To close expenses.		

KEY POINT

The two different sources of owners' equity are owner investment and earnings not withdrawn by the owner. In a proprietorship, the owner's investment and earnings are both recorded in the Capital account. In a corporation, the owners' investment is called *contributed capital* and the earnings not paid out to the owners (shareholders) are called *retained earnings.*

Now, the Income Summary account holds revenues, expenses, and net income.

Income Summary

Expenses	893,264,000	Revenues	923,795,000
		Balance (net income)	30,531,000

Finally, the Income Summary's balance is closed to Retained Earnings.

2003			
Feb. 2	Income Summary	30,531,000	
	Retained Earnings		30,531,000
	To close net income to Retained Earnings.		

This closing entry completes the closing process. Income Summary is zeroed out, and Retained Earnings now holds net income, as follows:

Income Summary

Exp.	893,264,000	Rev.	923,795,000
Closing	30,531,000	Net inc.	30,531,000

Retained Earnings

	Closing (net income) 30,531,000

If Forzani had had a net loss, Income Summary would have had a debit balance. To close a $100,000 loss, the closing entry credits Income Summary and debits Retained Earnings as follows:

2003			
Feb. 2	Retained Earnings	100,000	
	Income Summary		100,000
	To close Income Summary by transferring *net loss* to Retained Earnings.		

LEARNING

Sometimes accounting students view Retained Earnings as an asset, like cash. Remember, Retained Earnings is a part of shareholders' equity and therefore should have a normal *credit* balance. A *debit* balance in Retained Earnings is called a *deficit*.

Negative Retained Earnings Is Called a Deficit A loss or an accumulation of several years of losses may cause a debit balance in the Retained Earnings account. This condition—called a Retained Earnings **deficit** or accumulated deficit—is reported on the balance sheet as a negative amount in shareholders' equity. Black Hawk Mining Inc. (www.bhkmining.com) reported the following in its 2002 annual report:

Shareholders' Equity (in thousands)	
Contributed capital	$37,267
Deficit	(24,453)
Total shareholders' equity	$12,814

Corporations May Pay Dividends to Shareholders

REAL WORLD EXAMPLE

Public corporations are required to have an audit and file certain reports with the provincial securities commission. These requirements add to a corporation's expenses without increasing its income, but are necessary.

If the corporation has been profitable and has sufficient cash, it may distribute cash to the shareholders. Such distributions are called **dividends**. Dividends are similar to the withdrawals of cash made by the owner of a proprietorship or by a partner of a partnership. Dividends decrease both the assets and retained earnings of the corporation.

Some people think of Retained Earnings as a fund of cash. It is not, because Retained Earnings is an element of shareholders' equity; it is the balance of all of the company's income-earning activities. Retained earnings has no particular relationship to cash or any other asset. *Remember that cash dividends are paid out of assets, not out of retained earnings.*

Shareholders' Rights

The owner of a share has certain rights that are set out in the corporation's articles of incorporation; these vary from company to company, and even between classes of shares within a company. In addition, the shareholder may have other rights granted by the legislation under which the corporation receives its articles. While those rights outlined in the articles of incorporation are specific to an individual company, those set forth by legislation are shared by shareholders of all companies incorporated under that legislation. The articles of incorporation, for example, may specify that the shareholder of one class of common shares is entitled to one vote per share at shareholders' meetings, while the shareholder of another class of common shares is not entitled to vote. An example of a shared right is that, under the *Canada Business Corporations Act*, shareholders may require the directors of the company to call a meeting of the shareholders.

Some of the rights normally attached to common shares[1] are:

1. The right to sell the shares.
2. The right to vote at shareholders' meetings.
3. The right to a proportionate share of any dividends declared by the directors for that class of shares.
4. The right to receive a proportionate share of any assets, on the winding-up of the company, after the creditors and any classes of shares that rank above that class have been paid.
5. A preemptive right, the right to maintain one's proportionate ownership in the corporation. If a shareholder owns 5 percent of the outstanding common shares and the corporation decides to issue 100,000 new shares, the shareholder would be entitled to purchase 5,000 of the new shares. (This right, however, might not be given.)

Classes of Shares

Corporations issue different types of shares. The shares of a corporation may be either common or preferred.

KEY POINT

Most corporations are authorized to issue many more shares than they intend to issue originally. If the corporation wants to issue more than the authorized shares, the articles of incorporation must be amended. Amendment of the articles of incorporation requires shareholder approval.

Common and Preferred Shares

Every corporation issues *common shares*, the most basic form of share capital. Unless designated otherwise, the word *shares* or *stock* is understood to mean "common shares" or "common stock." Companies may issue different classes of common shares. For example, Rogers Communications Inc. (www.rogers.com) has issued Class A common shares, which carry the right to vote, and Class B common shares, which are nonvoting. (Classes of common shares may also be designated Series A, Series B, and so on, with each series having certain unique features, such as a fixed, stated dividend or a redemption feature.) There is a separate general-ledger account for each class of common shares. In describing a corporation, we would say the common shareholders are the owners of the business.

Investors who buy common shares take the ultimate risk with a corporation. The corporation makes no promises to pay them. If the corporation succeeds, it may distribute dividends to its shareholders, but if retained earnings and cash are too low, the shareholders may receive no dividends. The market value of the shares of successful corporations increases in value, and investors enjoy the benefit of selling the shares at a gain. The holder of common shares can earn income both from dividends and from increases in the value of the shares.

[1]The rights enumerated are basic rights common to incorporating legislation generally. For a more complete listing, the interested reader is referred to the *Canada Business Corporations Act* in *The Revised Statutes of Canada*.

But share prices can decrease, possibly leaving the investors holding worthless share certificates. Because common shareholders take a risky investment position, they demand increases in share prices, high dividends, or both. If the corporation does not accomplish these goals and many shareholders sell their shares, the market price will fall. Short of bankruptcy, this is one of the worst things that can happen to a corporation because it means that the corporation cannot easily raise capital as needed.

Preferred shares give their owners certain advantages over common shareholders. These benefits include the right to receive dividends before the common shareholders, and the right to receive assets before the common shareholders if the corporation liquidates. Corporations pay a fixed amount of dividends on preferred shares. Investors usually buy preferred shares to earn those fixed dividends. Often, preferred shares are cumulative, which means that if the preferred dividend is not paid in a year, the dividend from that year must be paid to the preferred shareholders before the common shareholders can receive a dividend in a later year. Because of the preferred shareholders' priorities, common shares represent the residual ownership in the corporation's assets after the liabilities and the claims of preferred shareholders have been subtracted. Often the right to vote is withheld from preferred shareholders. Westcoast Energy Inc., the energy transmission company, has several preferred shares issues. For example, Westcoast has $1.25 cumulative redeemable preferred shares and $1.40 cumulative preferred shares; $1.25 and $1.40 are the annual dividend rates. Companies may issue different classes of preferred shares (Class A and Class B or Series A and Series B, for example). Each class is recorded in a separate account.

Investors who buy preferred shares take less risk than do common shareholders. Why? Because corporations pay a specified amount of dividends on preferred shares. The preferred dividend may be a set amount, like that of Westcoast Energy Inc., or a fixed percentage of some number, such as the prime interest rate at the date of declaration of the dividend. For example, the December 31, 2002, annual report of Thomson Corporation (www.thomson.com), the information and publishing company, revealed that the company had outstanding Series II cumulative redeemable preferred shares whose quarterly dividend was 70 percent of the Canada prime bank rate and Series V cumulative redeemable preferred shares whose quarterly dividend was $1.25. Investors usually buy preferred shares to earn those dividends. Preferred shares' market values do not fluctuate much, so income is mostly from dividends.

Corporations issue preferred shares as opposed to common shares because preferred shares usually have no voting rights like most common shares have, and equity (ownership) is not diluted when preferred shares are issued. Preferred shares may be preferred by corporations to debt because dividends are payable at the discretion of the corporation. As well, the corporation is not compelled to redeem the preferred shares at a certain date, whereas the corporation must repay the debt at a certain date.

Preferred shares operate as a hybrid somewhere between common shares and long-term debt. Like debt, preferred shares pay a specified dividend. But like shares, the dividend becomes a liability only after the board of directors has declared the dividend. Also, there is no obligation to redeem preferred shares in the manner required by debt. Preferred shares that must be redeemed (paid back) by the corporation are a liability masquerading as a stock. Experienced investors treat mandatorily redeemable preferred shares as part of total liabilities, not as part of shareholders' equity. In fact, types of preferred shares must be accounted for as debt for accounting purposes. Further discussion of this aspect of preferred shares is covered in advanced accounting texts. While issuing preferred shares is a common way for a corporation to raise funds, not all corporations issue preferred shares. All corporations must have at least one common share.

The method of financing affects net income and income taxes to be paid. Corporations may prefer debt to preferred shares because dividend payments are

not tax deductible and interest payments are. Dividends are a distribution of assets created by earnings. On the other hand, individuals might prefer to hold preferred shares because the income tax rate on dividends they receive is lower than the tax rate they pay on interest they receive. It's for that reason that the dividend rate on a company's preferred shares is usually lower than the interest rate on bonds the company issues.

No-Par-Value Shares

No-par-value shares are shares that do not have a value assigned to them by the articles of incorporation. The board of directors assigns a value to the shares when they are issued; this value is known as the **stated value**. For example, Dajol Inc. has authorization to issue 100,000 common shares, having no par value assigned to them by the articles of incorporation. Dajol Inc. needs $50,000 at incorporation, and might issue 10,000 shares for $5.00 per share, 2,000 shares at $25.00 per share, or 1,000 shares at $50.00 per share, and so on. The point is that Dajol Inc. can assign whatever value to the shares the board of directors wishes. Normally, the stated value would be credited to Common Shares when the shares are issued.

The recorded value of a corporation's share capital or stated capital is the sum of the shares issued times the stated values of those shares at the time of issue. For example, if YDR Ltd. issued 1,000 common shares at a stated value of $8.00 per share, 2,000 shares at $12.00 per share, and 500 shares at $15.00 per share, its share capital or stated capital would be $39,500 [(1,000 × $8) + (2,000 × $12) + (500 × $15)].

The *Canada Business Corporations Act* and most provincial incorporating acts now require common and preferred shares to be issued without nominal or par value. The full amount of the proceeds from the sale of shares by a company must be allocated to the capital account for those shares. For example, if Canadian Tire Corporation, Limited were to issue 100 common shares for $2,500 (that is, the shares sold for $25.00 per share), $2,500 would be credited to Common Shares.

REAL WORLD EXAMPLE

If you looked at the balance sheet of a U.S. corporation, you might see that its common shares had been issued at *par value*. This means the board of directors assigned a value to the common shares. If the shares were sold for more than par value, the difference is credited to Contributed Surplus. Most Canadian corporations credit the capital account for those shares for the full amount of the net proceeds from the sale of the shares.

Stop & Think

For the following list of characteristics of share capital, indicate whether each characteristic would be likely to apply to preferred or common shares:

1. Stated dividend
2. Voting rights
3. Priority to receive assets in the event of liquidation
4. Cumulative

Answers:

	Preferred	Common
1.	Yes	No
2.	Maybe	Yes
3.	Yes	No
4.	Maybe	No

Issuing Shares

OBJECTIVE 2
Record the issuance of shares

Large corporations such as TransCanada Corporation, Research In Motion Limited, and Bombardier Inc. need huge quantities of money to operate. They cannot expect to finance all their operations through borrowing. They need capital that they can raise by issuing shares. The articles of incorporation that the incorporators receive from the federal or provincial government includes an *authorization of shares*—that is, a provision giving the government's permission for the business to issue (to sell) a certain number of shares. Corporations may sell the shares directly to the shareholders, or they may use the services of an *underwriter*,

KEY POINT

Owners invest in a corporation by buying shares. Issuance of shares increases the corporation's assets and shareholders' equity.

such as the brokerage firm RBC Dominion Securities or Scotia Capital Markets. The agreement between a corporation and its underwriter will vary, but typically the underwriter will commit to placing all of the share issue it can with its customers, and to buying any unsold shares for its own account. In another form of contract, the underwriter agrees to do its best to sell all of the share issue but makes no guarantees. The underwriter makes its money by selling the shares for a higher price than it pays to the corporation issuing the shares.

The corporation need not issue all the shares that the articles of incorporation allow—the number of authorized shares can, and often does, exceed the number of issued shares. Management may hold some shares back and issue them later if the need for additional capital arises. The shares that the corporation does issue to shareholders are called *issued shares*. Only by issuing shares—not by receiving authorization—does the corporation increase the asset and shareholder's equity amounts on its balance sheet.

The price that the shareholder pays to acquire shares from the corporation is called the *issue price*. A combination of market factors—including the company's comparative earnings record, financial position, prospects for success, and general business conditions—determines issue price. Investors will not pay more than market value for the shares. The following sections show how to account for the issuance of shares.

Issuing Common Shares

REAL WORLD EXAMPLE

The financial section of a newspaper often gives the market price of a company's shares, the dividend per share, as well as the dividend yield (which is the dividend per share ÷ market price per share).

Companies often advertise the issuance of their shares to attract investors. A good source of such information is SEDAR (System for Electronic Document Analysis and Retrieval). SEDAR (www.sedar.com) is the website developed under the authority of the Canadian Securities Administrators and administered by each of the provincial securities regulatory authorities. Exhibit 13-5 is a reproduction of the preliminary short-form prospectus dated February 17, 2004, of Southwestern Resources Corp.'s public offering of 1,000,000 common shares at $35.50 per share.

Issuing Common Shares at a Stated Value Suppose Research In Motion Limited (RIM) (www.rim.com) issues 10,000 common shares for cash, and the directors determine that the shares will be issued with a stated value (selling price) of $95 per share. The share issuance entry is

2004					
Jan.	8	Cash		950,000	
		Common Shares			950,000
		To issue common shares at $95.00 per share (10,000 × $95.00)			

We assume RIM received $950,000. The amount invested in the corporation, $950,000 in this case, is called share capital. The credit to Common Shares records an increase in the share capital of the corporation.

The following example shows RIM's shareholders' equity section in its annual report for the year ended March 1, 2003. RIM's annual report in Note 10 "Capital Stock" indicates that RIM's articles of incorporation permit it to issue an "...unlimited number of voting common shares... ." At March 1, 2003, RIM had issued 77,172,000 common shares for $874,007,000 (U.S.) and had 75,000 common share purchase warrants outstanding with a value of $370,000 (U.S.). The common shares were issued at an average value of $11.325 (calculated as $874,007,000 shares ÷ 77,172,000 common shares). The corporation would report shareholders' equity as follows:

Shareholders' Equity (in millions of U.S. dollars)

Contributed capital	
Common shares, unlimited number of shares authorized, 77,172,000 shares issued	$874
Deficit	(170)
Total shareholders' equity	$704

EXHIBIT 13-5

Announcement of Share Issue by Southwestern Resources Corp.

Preliminary Short Form Prospectus

New Issue — February 17, 2004

SOUTHWESTERN RESOURCES CORP.
$35,500,000
1,000,000 Common Shares

This short form prospectus ("Prospectus") qualifies for distribution (the "Offering") of 1,000,000 Common Shares (the "Common Shares") of Southwestern Resources Corp. ("Southwestern" or the "Company") at a price of $35.50 per Common Share pursuant to an underwriting agreement (the "Underwriting Agreement") dated February 17, 2004 between Southwestern, Raymond James Ltd. ("Raymond James"), Octagon Capital Corporation ("Octagon"), Haywood Securities Inc. ("Haywood") and National Bank Financial Inc. ("National Bank") (collectively, Raymond James, Octagon, Haywood and National Bank are referred to as the "Underwriters").

The offering price of $35.50 per Common Share was determined by negotiation between Southwestern and the Underwriters. The Common Shares are traded on The Toronto Stock Exchange (the "TSE") under the symbol "SWG". The price of the Common Shares as reported by the TSE at the close of business on February 16, 2004 was $38.10 per Common Share.

Price: $35.50 per Common Share

	Price to the Public	Underwriters' Fee	Net Proceeds to the Company
Per Common Share	$35.50	$1.775	$33.725
Total	$35,500,000	$1,775,000	$33,725,000

REAL WORLD EXAMPLE

Some corporations issue several classes of common shares—Class A shares and Class B shares. In a case like this, one class may have the rights of common shares and the other may have some restrictions or enhancements. For example, Magna International Inc.'s Class A shares have one vote each, while the Class B shares have 500 votes each.

The authorized common shares report the maximum number of shares the company may issue under its articles of incorporation.

STOP & THINK

Suppose RIM had total liabilities of $155 million (U.S.) on the balance-sheet date just given. What was RIM's debt ratio?

Answer: The debt ratio is 0.180, or 18.0%

$$\frac{\text{Total liabilities}}{\text{Total assets}} = \frac{\$155}{\$155 + \$704} = 0.180, \text{ or } 18\%$$

Issuing Common Shares for Assets Other Than Cash When a corporation issues shares in exchange for assets other than cash, it debits the assets received for their current market value and credits the capital accounts accordingly. The assets' prior book value does not matter because the shareholder will demand shares equal to the market value of the asset given. Suppose Gillan Corporation issued 25,000 common shares for equipment worth $25,000 and a building worth $125,000. The entry is

Nov. 12	Equipment		25,000	
	Building		125,000	
	Common Shares			150,000
	To issue 25,000 common shares in exchange for equipment and a building.			

Common Shares increases by the amount of the assets' *current market value*, $150,000 in this case; the stated value or value assigned to the shares would be $6.00 ($150,000 ÷ 25,000) per share.

LEARNING OBJ. 3

Whenever a corporation receives assets in exchange for share capital, assets *and* shareholders' equity will *increase*. Whenever a corporation distributes assets to shareholders (by paying dividends or retiring shares), assets and shareholders' equity will *decrease*.

REAL WORLD EXAMPLE

Sometimes, with publicly traded corporations, it is most objective to use the market value of the shares given in exchange for an asset as a measure of the asset's value.

Stop & Think

How did this transaction affect Gillan Corporation's contributed capital? Retained earnings? Total shareholders' equity?

Answer:

Contributed Capital	Effect on Retained Earnings	Total Shareholders' Equity
Increase $150,000	None	Increase $150,000

Issuing Preferred Shares

While not all corporations issue preferred shares, the recent edition of *Financial Reporting in Canada*[2] published by the Canadian Institute of Chartered Accountants reported that 63 of the 200 companies reporting, or 31.5 percent, mentioned preferred shares in the shareholders' equity section of their balance sheets. Accounting for preferred shares follows the pattern illustrated for common shares.

Assume the Arens Corporation articles of incorporation authorize issuance of 10,000 preferred shares with an annual dividend of $10.00 per share. On July 31, the company issues 1,000 shares at a stated price of $100.00 per share. The issuance entry is

July	31	Cash	100,000	
		Preferred Shares		100,000
		To issue 1,000 preferred shares for $100 per share (1,000 × $100).		

As was mentioned previously, sometimes preferred shares have characteristics that make them more like debt than equity. Such preferred shares are treated for accounting purposes as a liability rather than as part of equity. Investors also regard such preferred shares as debt rather than equity. Further discussion of the relevant issues is saved for a more advanced accounting course.

Stop & Think

From this list, calculate total contributed capital and total shareholders' equity:

Common Shares	$18,000
Preferred Shares	7,000
Retained Earnings	19,000

Answer: Total contributed capital = $25,000 ($18,000 + $7,000)
Total shareholders' equity = $44,000 ($25,000 + $19,000)

Ethical Considerations in Accounting for the Issuance of Shares

Issuance of shares for *cash* poses no serious ethical challenge. The company simply receives cash and issues the shares to the shareholders, giving them share certificates as evidence of their purchase.

[2]Byrd, C., I. Chen, and H. Chapman, *Financial Reporting in Canada 2002*, Twenty-seventh edition. (Toronto: Canadian Institute of Chartered Accountants, 2002), p. 343–344.

Issuing shares for assets other than cash can pose an ethical challenge, however. The company issuing the shares often wishes to record a large amount for the non-cash asset received (such as land or a building) and for the shares being issued. Why? Because large asset and equity amounts make the business look successful. The desire to look good can motivate a company to record a high amount for the assets.

A company is supposed to record an asset received at its current value. But one person's perception of a particular asset's market value can differ from another person's perception. One person may appraise land at a market value of $400,000. Another may honestly believe the land is worth only $300,000. A company receiving land in exchange for its shares must decide whether to record the land at $300,000, at $400,000, or at some amount in between.

The ethical course of action is to record the asset at its current market value, as determined by independent appraisers. Public corporations are rarely found guilty of *understating* the asset values on their balance sheets, but companies have been embarrassed by *overstating* asset values.

Donated Capital

Corporations occasionally receive gifts or *donations*. For example, a city council may offer a company free land to encourage it to locate in their city. The free land is called a donation. Also, a shareholder may make a donation to the corporation in the form of cash, land or other assets, or shares that the corporation can resell.

A donation is a gift that increases the assets of the corporation. However, the donor (giver) receives no ownership interest in the company in return. A transaction to receive a donation does not increase the corporation's revenue, and thus it does not affect income. Instead, the donation creates a special category of shareholders' equity called **donated capital**. The corporation records a donation by debiting the asset received at its current market value, and by crediting the Donated Capital account, which is a shareholders' equity account.

Suppose Burlington Ltd. receives 100 hectares of land as a donation from the city of Lethbridge, Alberta. The current market value of the land is $150,000. Burlington Ltd. records receipt of the donation as follows:

Apr.	18	Land	150,000	
		Donated Capital		150,000
		To receive land as a donation from the city.		

Donated capital is reported in the Shareholders' Equity section of the balance sheet as part of Contributed Capital, and follows the preferred and common shares.

Incorporation of a Going Business

You may dream of having your own business someday, or you may currently be a business proprietor or partner. Businesses that begin as a proprietorship or a partnership often incorporate at a later date. By incorporating a going business, the proprietor or partners avoid the unlimited liability for business debts. Corporations often pay income tax at a lower rate than individuals. And, as we discussed earlier, incorporating makes it easier to raise capital.

To account for the incorporation of a going business, we close the owner equity accounts of the prior entity and set up the shareholder equity accounts of the corporation. Suppose BC.com is a partnership owned by Joe Suzuki and Monica Lee. The partnership balance sheet, after all adjustments and closing entries, reports Joe Suzuki, Capital, of $100,000, and Monica Lee, Capital, of $140,000. They incorporate their business as BC.com Inc. with an authorization to issue 1,000,000 common shares. Joe and Monica agree to receive common shares equal

Accounting and the e-World

UPS Delivers the Goods at Record-Breaking IPO

If you wanted to buy shares in a company that operates in the global electronic marketplace, what companies come to mind—pioneering dot.coms like Amazon.com or E-Bay? Surprisingly, one such company is a 97-year-old business whose workers drive old-fashioned trucks and deliver parcels to your door. United Parcel Service (UPS) is a traditional business that raised a record-breaking $5.5 billion (U.S.) at its initial public offering (IPO) when it went public and sold its shares. All this money came from investors who saw UPS as the sign of the new economy.

The electronic marketplace and UPS's profits go hand in hand. After all, the goods you purchase online have to be delivered by someone—UPS, Federal Express, or Canada Post. As it turned out, UPS picked the perfect time to go public in the U.S.—the 2000 Christmas shopping season. That year set a record for Internet purchases.

Why would UPS sell its shares to the public? To build a cross-border U.S./European infrastructure, UPS determined it would need to acquire and merge with foreign firms. That required a lot of money. During the first hours of trading in UPS shares, the company's share price soared 40 percent as investors bid up the shares. By the end of a week, the UPS workforce included 10,000 new millionaires.

UPS sparked investor excitement because its financial position and its technology are as strong as the workers who move its packages. UPS spends $1 billion a year on technology and boasts a database that lets you track a package from Halifax to Beijing. With all of these advantages, UPS's profits are three times higher than those of the U.S. Postal Service, even though it earns only half the revenue. And UPS's operating margin is twice that of FDX Corp., the parent company of Federal Express.

Based on: Avital Louria Hahn, "Men in Brown: A Growth Story—UPS Recasts itself for IPO," *The Investment Dealers' Digest: IDD*, December 13, 1999, p. 35. Elise Ackerman, "UPS Delivers as IPO Investors Give the World's No. 1 Package-Delivery Company Full Dot.com Treatment," *U.S. News & World Report*, November 22, 1999, p. 53. Jenny Anderson, "Up, UPS and Away," *Institutional Investor*, January 2000, pp. 96–98.

in stated value to their partnership equity balances. The equity balances represent the net assets of the partnership. The entry to record the incorporation of the business is

Feb.	1	Joe Suzuki, Capital	100,000	
		Monica Lee, Capital	140,000	
		Common Shares		240,000
		To incorporate the business, close the capital accounts of the partnership, and issue common shares to the incorporators.		

Organization Cost

The costs of organizing a corporation include legal fees for preparing documents and advising on procedures, fees, and taxes paid to the incorporating jurisdiction, and charges by promoters for selling the company's shares. These costs are

grouped in an account titled Organization Cost, which is an asset because these costs contribute to a business's start-up. Suppose BBV Holdings Inc. pays legal fees and incorporation fees of $5,000 to organize the corporation under the *Canada Business Corporations Act* in Newfoundland. In addition, an investment dealer charges a fee of $15,000 for selling 30,000 common shares of BBV Holdings Inc. for $225,000 and receives 2,000 common shares as payment. BBV Holdings Inc.'s journal entries to record these organization costs are

Mar.	31	Organization Cost	5,000	
		Cash		5,000
		Legal fees and incorporation fees to organize the corporation.		
Apr.	3	Cash	225,000	
		Organization Cost	15,000	
		Common Shares		240,000
		To record receipt of funds from sale of common shares and issue of shares to investment dealer for selling shares in organization.		

Organization cost is an *intangible asset*, reported on the balance sheet along with patents, trademarks, goodwill, and any other intangibles. We know that intangible assets, with the exception of goodwill, should be amortized over their useful lives, and organization costs will benefit the corporation for as long as the corporation operates. But how long will that be? We cannot know in advance. The *Income Tax Act* allows corporations to expense a portion of organization costs against taxable income. While the *CICA Handbook* does not require organization costs to be amortized, most companies amortize organization costs over a short time period because of their relatively small size. As is true with other intangibles, amortization expense for the year should be disclosed in the financial statements.

Summary Review of Accounting for Shares

OBJECTIVE 3
Prepare the shareholders' equity section of a corporation's balance sheet

Let's review the first half of this chapter by showing the shareholders' equity section of Envoy Corporation's balance sheet at December 31, 2005, in Exhibit 13-6. (Assume that all figures, which are arbitrary, are correct.) Note the two sections of shareholders' equity: contributed capital and retained earnings. Also observe the order of the contributed capital accounts: preferred shares, common shares, and contributed surplus.



EXHIBIT 13-6

Part of Envoy Corporation's Balance Sheet

ENVOY CORPORATION
Partial Balance Sheet
December 31, 2005

Shareholders' Equity

Contributed capital	
Preferred shares, $5.00, 10,000 shares authorized, 1,000 shares issued	$ 50,000
Common shares, 10,000 shares authorized, 4,000 shares issued	80,000
Total preferred and common shares	130,000
Contributed surplus—Donated capital	40,000
Total contributed capital	170,000
Retained earnings	15,000
Total shareholders' equity	$185,000

Stop & Think

Examine Envoy Corporation's shareholders' equity in Exhibit 13-6, and answer these questions.

1. How much did Envoy Corporation's preferred shareholders invest in the corporation?
2. How much did the common shareholders invest in Envoy Corporation?
3. What did the shareholders get for their investments in the company?
4. How does the donated capital differ from the other capital accounts?

Answers:

1. $50,000
2. $80,000
3. The shareholders received shares, which represents their ownership in the net assets of the corporation.
4. Donated capital represents a donation to the company for which the donor received no ownership interest in the assets of the company. The other contributed capital accounts represent what the shareholders paid for their ownership in the company's assets.

Now review the Decision Guidelines feature to solidify your understanding of shareholders' equity as it is reported on the balance sheet.

Decision Guidelines — Shareholders' Equity of a Corporation

Suppose you are interested in investing in shares. The following guidelines will help you sort out some of the relevant factors you should consider before making your decision.

Decision	Guidelines
What are the two main segments of shareholders' equity?	• Contributed capital • Retained earnings
Which is more permanent, contributed capital or retained earnings?	Contributed capital is more permanent because corporations may use their retained earnings for distributing dividends to the shareholders.
How are contributed capital and retained earnings • Similar? • Different?	• Both represent the shareholders' equity (ownership) in the net assets of the corporation. • Contributed capital and retained earnings come from different sources: a. Contributed capital comes from the corporation's shareholders, who invested in the company. b. Retained earnings comes from the corporation's customers. It was earned by the company's profitable operations.
What categories of contributed capital appear most often on corporation financial statements?	• Preferred shares • Common shares

Mid-Chapter Summary Problems for Your Review

1. Test your understanding of the first half of this chapter by answering whether each of the following statements is true or false:
   a. A shareholder may bind the corporation to a contract.
   b. The policy-making body in a corporation is called the board of directors.
   c. The owner of 100 preferred shares has greater voting rights than the owner of 100 common shares.
   d. A company incorporated under the *Canada Business Corporations Act* must assign the proceeds of a share issue to the capital account for that type of share.
   e. All common shares issued and outstanding have equal voting rights.
   f. Issuance of 1,000 common shares at $12 per share increases shareholders' equity by $12,000.
   g. The stated value of a share is the value assigned to the shares by the company issuing them at the date issued.
   h. A corporation issues its preferred shares in exchange for land and a building with a combined market value of $200,000. This transaction increases the corporation's shareholders' equity by $200,000 regardless of the assets' prior book value.
   i. Preferred shares are a riskier investment than common shares.

2. Leith Technologies Inc., incorporated under the *Canada Business Corporations Act*, had three transactions during the year involving its common shares. On January 15, 2005, 50,000 Class A voting shares were issued with a stated value of $8.00 per share. On February 28, 2005, 10,000 Class B non-voting shares with a stated value of $10.00 per share were issued. On August 8, 2005, 15,000 Class B shares were issued in exchange for land with a market value of $165,000. Leith's articles of incorporation state that 100,000 Class A voting and 200,000 Class B non-voting common shares are authorized.

a. Prepare the journal entry to record the transaction of January 15, 2005.
b. Prepare the journal entry to record the transaction of February 28, 2005.
c. Prepare the journal entry to record the transaction of August 8, 2005.
d. Create the shareholders' equity section for Leith Technologies Inc. after the three transactions have taken place.
e. What is the total contributed capital of the company?
f. How did Leith Technologies Inc. withhold the voting privilege from its Class B common shareholders?

Solutions

1. Answers to true-or-false statements:

a. False	b. True	c. False	d. True	e. False
f. True	g. True	h. True	i. False	

2.

	2005				
a.	Jan.	15	Cash	400,000	
			Common Shares—Class A		400,000
			To issue Class A common shares at $8.00 per share (50,000 × $8.00).		
b.	Feb.	28	Cash	100,000	
			Common Shares—Class B		100,000
			To issue Class B common shares at $10.00 per share (10,000 × $10.00).		
c.	Aug.	8	Land	165,000	
			Common Shares—Class B		165,000
			To issue 15,000 common shares at $11.00 per share in exchange for land.		

d.

Shareholders' Equity	
Contributed capital	
Common shares, Class A voting, 100,000 shares authorized, 50,000 shares issued	$400,000
Common shares, Class B non-voting, 200,000 shares authorized, 25,000 shares issued	265,000
Total contributed capital	$665,000

e. Contributed capital is $665,000.

f. The voting privilege was withheld by specific agreement; the articles of incorporation specified the Class B common shares were non-voting.

Cyber Coach

Visit the Study Guide on the Media Companion CD-ROM and the Student Resources area of the *Accounting* Companion Website for extra practice with the new material in Chapter 13.

www.pearsoned.ca/horngren

Accounting for Cash Dividends

Corporations share their wealth with the shareholders through dividends. Corporations declare dividends from *retained earnings* and usually pay the dividends with *cash*. The corporation must have enough retained earnings to declare the dividend and also have enough cash to pay the dividend.

Dividend Dates

A corporation must declare a dividend before paying it. The board of directors declares the dividend. The corporation has no obligation to pay a dividend until the board declares one. However, once the dividend is declared, it becomes a legal liability. Three relevant dates for dividends are

1. ***Declaration date*** On the declaration date, the board of directors announces the intention to pay the dividend and the declaration creates a liability for the corporation.

2. ***Date of record*** Those shareholders holding the shares on the date of record—a few weeks after declaration—will receive the dividend when it is paid.
3. ***Payment date*** Payment of the dividend usually follows the record date by two to four weeks.

Dividends on Preferred and Common Shares

OBJECTIVE 4
Account for cash dividends

Declaration of a cash dividend is recorded by debiting Retained Earnings and crediting Dividends Payable as follows:[3]

Oct.	3	Retained Earnings	XXX	
		Dividends Payable		XXX
		To declare a cash dividend.		

Payment of the dividend occurs, as was noted above, on the payment date, and is recorded as follows:

Nov.	15	Dividends Payable	XXX	
		Cash		XXX
		To pay a cash dividend.		

Dividends Payable is a current liability. When a company has issued both preferred and common shares, the preferred shareholders receive their dividends first. The common shareholders receive dividends only if the total declared dividend is large enough to satisfy the preferred requirements.

Val Morin Industries Inc. has 10,000 shares of $1.50 cumulative preferred shares outstanding plus common shares. Exhibit 13-7 shows the division of dividends between the preferred shares and common shares for two situations.

If Val Morin Industries Inc.'s annual dividend is large enough to cover the preferred dividend for the year (Case B in Exhibit 13-7), the preferred shareholders receive their regular dividend and the common shareholders receive the remainder. But if the year's dividend is just equal to or less than the preferred dividend (Case A in Exhibit 13-7), the preferred shareholders receive the entire dividend, and the common shareholders receive nothing that year.

We noted that preferred shareholders enjoy the advantage of priority over common shareholders in receiving dividends. The various features or sweeteners for preferred shares are explained on page 708. The dividend preference is



EXHIBIT 13-7

Dividing a Dividend between Preferred Shares and Common Shares of Val Morin Industries Inc.

Case A: Total dividend of $15,000:		
Preferred dividend (The full $15,000 goes to the preferred shares because the annual preferred dividend is $15,000 ($1.50 × 10,000).)	$15,000	
Common dividend (none, because the total dividend declared did not exceed the preferred dividend for the year)	0	
	$15,000	
Case B: Total dividend of $50,000:		
Preferred dividend ($1.50 × 10,000)	$15,000	
Common dividend ($50,000 − $15,000)	35,000	
	$50,000	

[3]Some accountants debit a Dividends account, which is closed to Retained Earnings, but most businesses debit Retained Earnings as shown here.

normally stated as a dollar amount. For example, the preferred shares may be "$3 preferred," meaning that the shareholders are entitled to an annual dividend of $3 per share.

Stop & Think

CRS Robotics Inc. was organized on January 1, 2004, with 500,000 shares authorized; 200,000 shares were issued on January 5, 2004. CRS Robotics Inc. earned $250,000 during 2004 and declared a dividend of $0.25 per share on November 30, 2004, payable to shareholders on January 5, 2005.

(1) Journalize the declaration and payment of the dividend.

(2) Compute the balance of retained earnings on December 31, 2004.

Answers:

(1) November 30, 2004, declaration:

Retained Earnings	50,000	
Dividends Payable		50,000
(200,000 shares × $0.25)		

January 5, 2005, payment:

Dividends Payable	50,000	
Cash		50,000

(2) The balance in retained earnings is $200,000 ($250,000 – $50,000). The declaration on November 30, 2004—not the payment on January 5, 2005—reduced retained earnings.

KEY POINT

Dividends are *not* an expense, but a distribution of earnings to owners. Cash dividends, like withdrawals, reduce assets and shareholders' equity.

KEY POINT

To declare cash dividends, a corporation must have (1) a credit balance in Retained Earnings, (2) adequate cash, and (3) approval by the board of directors.

Dividends on Cumulative and Noncumulative Preferred Shares

The allocation of dividends may be complex if the preferred shares are *cumulative*. Corporations sometimes fail to pay a dividend to their preferred shareholders. The missed dividends are said to be *in arrears*. The owners of **cumulative preferred shares** must receive all dividends in arrears plus the current year's dividend before the corporation pays dividends to the common shareholders. The cumulative feature is not automatic to preferred shares but must be assigned to the preferred shares in the articles of incorporation.

LEARNING

"Cumulative" means that any dividends not declared in a given year will accumulate, or carry over, to the future. Dividends cannot accumulate on common shares.

As noted above, the preferred shares of Val Morin Industries Inc. are cumulative. Suppose the company did not distribute the 2004 preferred dividend of $15,000. Before paying dividends to its common shareholders in 2005, the company must first pay preferred dividends of $15,000 for each of 2004 and 2005, a total of $30,000.

When a company has more than one class of preferred shares or common shares, the division of dividends among the various classes of shares follows this same pattern: the most senior preferred shares get the first dividends, and so on.

Assume that Val Morin Industries Inc. did not distribute its 2004 preferred dividend. In 2005, the company declares a $100,000 dividend. The entry to record the declaration is

2005					
Sept.	6	Retained Earnings		100,000	
		Dividends Payable, Preferred			30,000
		Dividends Payable, Common			70,000
		To declare a cash dividend. Preferred dividends are $30,000 ($15,000 × 2); common dividends are $70,000 ($100,000 – $30,000).			

If the preferred shares are not designated as cumulative, the corporation is not obligated to pay dividends in arrears. Suppose that the Val Morin Industries Inc. preferred shares were not cumulative, and the company did not distribute the 2004 preferred dividend of $15,000. The preferred shareholders would lose the 2004 dividend forever. Of course, the common shareholders would not receive a 2004 dividend either. Before paying any common dividends in 2005, the company would have to pay the 2005 preferred dividend of $15,000.

Having dividends in arrears on cumulative preferred shares is *not* a liability to the corporation. (A liability for dividends arises only after the board of directors declares the dividend.) Nevertheless, a corporation must report cumulative preferred dividends in arrears in the notes to the financial statements. This information alerts common shareholders to how much in cumulative preferred dividends must be paid before the common shareholders will receive any dividends.

Note disclosure of cumulative preferred dividends might take the following form. Observe the two references to note 3 in this section of the balance sheet. The "$1.50" after "Preferred shares" is the dividend rate.

Preferred shares, $1.50, 50,000 shares authorized, 10,000 shares issued (Note 3)	$ 80,000
Common shares, 100,000 shares authorized, 40,000 shares issued	200,000
Retained earnings (Note 3)	414,000

Note 3: Cumulative preferred dividends in arrears. At December 31, 2005, dividends on the company's $1.50 preferred shares were in arrears for 2004 and 2005, in the amount of $30,000 ($1.50 × 10,000 × 2 years).

STOP & THINK

Trivision Corp. has outstanding 20,000 common shares and 10,000 $2.00 cumulative preferred shares. The company has declared no dividends for the past two years but plans to pay $90,000 this year. Compute the dividends for the preferred and common shares.

Answer:

Preferred Shares:	
Dividends in arrears ($2.00 × 10,000 × 2)	$40,000
Current dividend	20,000
Total to Preferred Shares	$60,000
Common Shares:	
Remainder of dividend ($90,000 – $60,000)	30,000
Total dividend	$90,000

Convertible Preferred Shares

Convertible preferred shares may be exchanged by the preferred shareholders, if they choose, for another specified class of shares in the corporation. For example, the preferred shares of Renewal Resources Inc. are convertible into the company's common shares. A note to Renewal's balance sheet describes the conversion terms as follows:

> The . . . preferred shares are convertible at the rate of 7.00 common shares for each preferred share outstanding.

KEY POINT

Convertible preferred shares may be exchanged for common shares at the shareholder's option.

If you owned 100 Renewal convertible preferred shares, you could convert them into 700 (100 × 7.00) common shares. Under what condition would you exercise the conversion privilege? You would do so if the market value of the common shares that you could receive from conversion exceeded the market value of the preferred shares that you presently held. This way, you as an investor could increase your personal wealth.

Renewal Resources Inc. convertible preferred shares were issued at $100 per share, and the common shares at $1. The company would record the conversion at the value of the 100 preferred shares on the Renewal Resources Inc. books, or $10,000 (100 × $100). The conversion of the 100 preferred shares into 700 common shares would be recorded as follows:

Mar.	7	Preferred Shares	10,000	
		Common Shares		10,000
		Conversion of preferred shares into common. (100 preferred shares converted into 700 common shares).		

At this point, the new common shares cannot be converted back to preferred shares.

Stop & Think

Record the conversion of 100 $10.00 convertible preferred shares that were originally issued at $150 per share. Each preferred share is convertible into 4 common shares.

Answer:

Preferred Shares (100 × $150)	15,000	
Common Shares		15,000
To record conversion of 100 preferred shares into 400 common shares (4 × 100 = 400 common shares would be issued)		

Summary

Preferred shares, as we see, offer alternative features not available to common shares. Preferred shares may be cumulative or not cumulative, and convertible or not convertible. In addition, preferred shares are usually preferred when dividends are distributed, and when the assets are distributed to shareholders upon liquidation of the company.

OBJECTIVE 5
Use different share values in decision making

Different Values of Shares

The business community refers to several different *share values*. Market value and book value are used for various investor decisions.

Market Value

A share's **market value**, or *market price*, is the price for which a person could buy or sell a share. The issuing corporation's net income, financial position, its future prospects, and the general economic conditions determine market value. The Internet and most newspapers report the market price of many shares. Most companies' websites track their share prices. Corporate annual reports generally provide quarterly market price data for the past five or ten years. *In almost all cases, shareholders are more concerned about the market value of a share than its book value.* At

December 30, 2003, the common shares of Winpak Ltd. (www.winpak.com), the Winnipeg-based manufacturer of packaging, were *listed at* (an alternative term is *quoted at*) $100.00, which meant they sold for, or could be bought for, $100.00 per share. The purchase of 100 common shares of Winpak Ltd. would cost $10,000 ($100.00 × 100), plus a commission. If you were selling 100 common shares, you would receive cash of $10,000 less a commission. The commission is the fee an investor pays to a stockbroker for buying or selling the shares. If you buy shares in Winpak Ltd. from another investor, Winpak Ltd. gets no cash. The transaction is a sale between investors. Winpak Ltd. records only the change in shareholder name.

REAL WORLD EXAMPLE

A change in the market price of a company's shares does not affect the corporation unless the corporation decides to issue additional shares or repurchase its own shares. Most share transactions are between shareholders.

Book Value

The **book value** of a share is the amount of shareholders' equity on the company's books for each share. If the company has only common shares outstanding, divide total shareholders' equity by the number of shares *outstanding*. A company with shareholders' equity of $180,000 and 5,000 common shares outstanding has book value of $36 per share ($180,000 ÷ 5,000 shares).

If the company has both preferred and common shares outstanding, the preferred shareholders have the first claim to shareholders' equity. Ordinarily, preferred shares have a specified liquidation value. The book value of preferred shares is usually their liquidation value plus any cumulative dividends in arrears on the shares. The book value *per share* equals the sum of the liquidation value and any cumulative dividends in arrears divided by the number of preferred shares outstanding. After the corporation computes the preferred share's book value, it computes the book value per common share. The corporation divides the common equity (total shareholders' equity minus preferred equity) by the number of common shares outstanding.

LEARNING

Book value per share uses the number of shares outstanding, not the number of shares authorized.

Therefore, we subtract preferred equity from total equity to compute the book value of the common shares, and divide this amount by the number of common shares outstanding to determine the book value per common share. To illustrate, Garner Corp. reports the following amounts:

Shareholders' Equity

Contributed capital	
Preferred shares, $7.00, 5,000 shares authorized, 1,000 shares issued	$100,000
Common shares, 20,000 shares authorized, 5,000 shares issued	150,000
Total contributed capital	250,000
Retained earnings	90,000
Total shareholders' equity	$340,000

Suppose that four years of cumulative preferred dividends (including the current year) are in arrears. The book value for the common shares follow:

Total shareholders' equity	$340,000
Less: Shareholders' equity allocated to preferred	128,000*
Shareholders' equity available for common shareholders	$212,000
Book value per share ($212,000 ÷ 5,000 shares)	$42.40

*$100,000 + ($7.00 × 1,000 × 4) = $128,000

Using Book Value in Decision Making How is book value used in decision making? Book value may be a factor in determining the price to pay for a closely-held corporation. Also, a company may buy out a shareholder by agreeing to pay the book value of the shareholder's shares.

Some investors compare the book value of a share with its market value. The idea is that a stock selling below book value is underpriced and thus is a good buy. But the relationship between book value and market value is far from clear. Other investors believe that, if a stock sells at a price below book value, the company must be experiencing difficulty. Exhibit 13-8 contrasts the book values and market prices for the common shares of three well-known companies. In all three cases, the share price, which is the market value, exceeds book value—a sign of success. Winpak Ltd.'s share price far exceeds its book value.

OBJECTIVE 6
Evaluate a company's return on assets and return on shareholders' equity

Evaluating Operations

Investors and creditors are constantly comparing companies' profits. The Forzani Group's net income may not be comparable to that of a company in the oil and gas business, such as EnCana Corporation, or of a brewery, such as Sleeman Breweries Ltd. It is difficult to compare an established company, such as BCE Inc., to a relatively young company, such as Infowave Software, Inc. of Burnaby, B.C. To compare companies, investors, creditors, and managers use standard profitability ratios. Two key measures are the rate of return on total assets and the rate of return on shareholders' equity.

Rate of Return on Total Assets

The **rate of return on total assets**, or simply **return on assets**, measures a company's success in using its assets to earn income for those who are financing the business. Creditors have lent money to the corporation to earn interest. Shareholders have invested in the corporation's shares and expect the company to earn net income.

The sum of interest expense and net income is the return to the two groups that have financed the corporation's assets, and this is the numerator of the return on assets ratio. The denominator is average total assets. Return on assets is computed as follows, using the actual data from the March 31, 2003, annual report of Big Rock Brewery Income Trust (www.bigrockbeer.com), the Alberta brewery (amounts in millions of dollars):

$$\text{Rate of return on total assets} = \frac{\text{Net income + Interest expense}}{\text{Average total assets}} = \frac{\$2.29 + \$0.28}{(\$36.58 + \$33.06)/2} = \frac{\$2.57}{\$34.82} = 0.074, \text{ or } 7.4\%$$

EXHIBIT 13-8

Book Value and Market Value

	Year-End Book Value	Approximate Fourth-Quarter Market-Value Range
Enbridge Inc. (December 31, 2002)	$17.90	$42.50–$45.50
Sobeys Inc. (May 3, 2003)	$21.81	$37.00–$41.50
Winpak Ltd. (December 30, 2003)	$34.98	$100.00–$120.00

Net income and interest expense are taken from the income statement and the notes. Average total assets are computed from the beginning and ending balance sheets. How is this profitability measure used in decision making? It is used to compare companies. By relating the sum of net income and interest expense to average total assets, we have a standard measure that describes the profitability of all types of companies.

What is a good rate of return on total assets? There is no single answer to this question because rates of return vary widely by industry. For example, consumer products companies earn much higher returns than do utilities or grocery store chains. In most industries, a return on assets of 10 percent is considered very good.

Rate of Return on Common Shareholders' Equity

Rate of return on common shareholders' equity, often called **return on equity**, shows the relationship between net income and average common shareholders' equity. The numerator is net income minus preferred dividends. This information is taken from the income statement and statement of retained earnings. Preferred dividends are subtracted because the preferred shareholders have the first claim to dividends from the company's net income. The denominator is average *common shareholders' equity*—total shareholders' equity minus preferred equity. Big Rock Brewery's rate of return on common shareholders' equity for March 31, 2003, is computed as follows (amounts in millions):

$$\text{Rate of return on common shareholders' equity} = \frac{\text{Net income} - \text{Preferred dividends}}{\text{Average common shareholders' equity}} = \frac{\$2.29 - \$0}{(\$24.75 + \$21.78)/2} = \frac{\$2.29}{\$23.27} = 0.098, \text{ or } 9.8\%$$

Observe that the return on equity (9.8 percent) is higher than the return on assets (7.4 percent). This difference results from the interest expense component of return on assets. Companies such as Big Rock Brewery borrow at one rate, say, 7.5 percent, and invest the funds to earn a higher rate, say, 9.5 percent. Borrowing at a lower rate than the return on investments is called *using leverage*. During good times, leverage produces high returns for shareholders. However, too much borrowing can make it difficult to pay the interest on the debt. The company's creditors are guaranteed a fixed rate of return on their loans. The shareholders, conversely, have no guarantee that the corporation will earn net income, so their investments are riskier. Consequently, shareholders demand a higher rate of return than do creditors, and this explains why return on equity should exceed return on assets. If return on assets is higher than return on equity, the company may be in trouble.

LEARNING

The dictionary definition of leverage is the use of a small force to move a larger object. *Financial leverage* occurs when a small change in income creates a larger return to the common shareholders.

Investors and creditors use return on common shareholders' equity in much the same way as they use return on total assets—to compare companies. The higher the rate of return, the more successful the company. A 12 percent return on common shareholders' equity is considered quite good in most industries. Investors also compare a company's return on shareholders' equity to interest rates available in the market. If interest rates are almost as high as return on equity, many investors will lend their money to earn interest rather than invest in common shares. They choose to forego the extra risk of investing in shares when the rate of return on equity is too low.

Stop & Think

The financial statements of Kelly Resources Corp. reported:

	2005	2004
Net income	$ 80,000	$ 90,000
Interest expense	20,000	24,000
$6.00 Preferred shares (1,000 shares)	100,000	100,000
Common shares	200,000	200,000
Retained earnings	180,000	160,000
Total assets	840,000	760,000

Dividends were paid to preferred shareholders in 2004 and 2005. Dividends of $54,000 were declared and paid to common shareholders in 2005. Compute for 2005 (1) the return on assets and (2) the return on common shareholders' equity.

Answers:

(1) 12.5%:

$$\frac{\$80{,}000 + \$20{,}000}{(\$840{,}000 + \$760{,}000)/2} = 0.125, \text{ or } 12.5\%$$

(2) 20%:

$$\frac{\$80{,}000 - (\$6.00 \times 1{,}000)}{(\$380{,}000 + \$360{,}000)/2} = 0.20, \text{ or } 20\%$$

Compare the return on assets (ROA) and return on equity (ROE). Is there a favourable or unfavourable relationship between the two ratios?

Answer:

The ROE is higher than the ROA, which indicates that the company is using leverage favourably.

OBJECTIVE 7
Account for a corporation's income tax

Accounting for Income Taxes by Corporations

Corporations pay taxes on their income in the same way that individuals do. Corporate and personal tax rates differ, however. The federal tax rate for manufacturing corporations with income in excess of $225,000 was 22.12 percent in 2003. Canadian-controlled private corporations with income of less than $225,000 and meeting certain other conditions pay taxes at a lower rate. In addition, all the provinces and the Yukon, Nunavit, and Northwest Territories levy taxes on corporations at rates ranging from 2.5 percent to 16.0 percent.

For each period, the corporation measures income tax expense and the related income tax payable. Corporate strategy is almost always directed at minimizing the income tax payable because that is the amount of cash the company must pay the government. But the main accounting issue centres on the measurement of net income. Therefore, accountants strive for a reasonable measure of income tax expense. Total revenues minus total expenses, including income tax expense, produces net income.

Income Tax Expense, an expense on the income statement, is based on **pretax accounting income**, or income before income tax, from the income statement. Income Tax Payable, a liability on the balance sheet, is based on **taxable income** from the income tax return filed with Canada Revenue Agency and the provincial government. Taxable income is the basis for computing the amount of tax to *pay* the governments. Pretax accounting income and taxable income are rarely the same amount.

Income tax expense	=	Pretax accounting income (from income statement)	×	Income tax rate

Income tax payable	=	Taxable income (from tax return)	×	Income tax rate

The authors thank Jean Marie Hudson for suggesting this presentation.

Some revenues and expenses enter the determination of accounting income in periods different from the periods in which they enter the determination of taxable income. Over a period of many years, total pretax accounting income may equal total taxable income, but for any one year the two income amounts are likely to differ.

There are a number of reasons why pretax income might not equal taxable income. We will discuss the most common reason, which accounting standards define as a **temporary difference**, or **timing difference.**

A temporary difference can arise when an expense is deducted on the financial statements in one year but is not deductible for tax purposes until the expense is paid. Warranty expense is an example. The matching principle requires that warranty expense be deducted from income in the same period the product or service is sold. However, Canada Revenue Agency does not allow warranty expense to be deducted from income for tax purposes until the expense is incurred and paid. For example, suppose SR Electric Products Ltd. sells a toaster oven in 2003 for $80 and the product is warrantied for one year. SR Electric Products Ltd. estimates a warranty cost of $20 and deducts that amount as an expense on its income statement when calculating *pretax accounting income* for the year ended December 31, 2003. This $20 must be added back to pretax accounting income to calculate SR Electric Products Ltd.'s *taxable income* for 2003. If we assume the company has a pretax accounting income of $100 (which reflects the $20 warranty expense) and (for ease of computation) a combined federal and provincial income tax rate of 30 percent:

Income tax expense	=	pretax accounting income × tax rate
	=	$100 × 0.30 = $30
Income tax payable	=	taxable income × income tax rate
	=	($100 + $20) × 0.30 = $36
Difference	=	$36 – $30 = $6

When income tax expense and income tax payable amounts are not the same in a given period, the difference is known as a future income tax asset or a future income tax liability, depending on the effect of the timing difference. Section 3465 of the *CICA Handbook* calls the $6 difference in the example above a **future income tax asset** because it represents a future benefit to SR Electric Products Ltd. The $6 difference will reverse in a future year when cash is actually paid for a repair under warranty and this warranty payment then becomes deductible for income tax purposes.

The journal entry to record SR Electric Products Ltd.'s income tax expense and income tax payable is:

2003			
Dec. 31	Future income tax asset	6	
	Income tax expense	30	
	Income tax payable		36
	To record income tax expense for 2003.		

Another common temporary difference occurs when a company uses amortization rates for accounting purposes that are different from the Canada Revenue Agency capital cost allowance rates used for income tax purposes. In this

situation, the temporary difference will lead to *either* a future income tax asset or a future income tax liability. Often, the amortization expenses deducted for accounting purposes are less than the capital cost allowances allowed for income tax purposes, which leads to a **future income tax liability.** You would follow the same method as above to calculate the future income tax liability.

Stop & Think

Peters Corp. reported $150,000 of income (income statement) before amortization. Straight-line (book) amortization was $20,000, and capital cost allowance was $25,000. Assume a 40 percent tax rate. (1) Calculate Peters Corp.'s income tax expense, income tax payable, and future income tax asset or liability for the year. (2) Does Peters Corp. have a future income tax asset or liability?

Answers:

(1) Income tax expense: ($150,000 – $20,000) × 0.40 = $52,000
Income tax payable: ($150,000 – $25,000) × 0.40 = $50,000
Future income tax liability: $52,000 – $50,000 = $2,000
(2) Peters Corp. has a future income tax liability because the expense exceeds the payable.

DECISION GUIDELINES — Corporate Dividends, Share Values, Evaluation of Operations, and Corporate Income Tax

Suppose you operate a Forzani Group Sports Experts franchise near your school in Laval, Quebec. You are naturally interested in how well The Forzani Group Ltd. as a whole is doing. In particular, are sales for The Forzani Group Ltd. trending upwards or downwards or are they flat? What is the market value of Forzani's shares? What are the rates of return on Forzani's assets and equity? These Decision Guidelines will help you evaluate the company.

Decision	Guidelines
Dividends	
When can a company declare a cash dividend?	• Must have enough retained earnings to declare the dividend. • Must have enough cash to pay the dividend.
What happens with a dividend?	• The corporation's board of directors declares the dividend. The dividend then becomes a liability of the corporation. • The date of record fixes who will receive the dividend. • Payment of the dividend occurs later.
Who receives the dividend?	• Preferred shareholders receive their dividends first. Preferred dividends have a specified rate. • Common shareholders receive the remainder.
Share Values	
How much would an investor pay for a share?	Its market value.
What is book value's role in decision making?	Sometimes used to help determine the market value of a share that is not traded on a stock exchange.

(continued)

Decision	Guidelines
Evaluating Operations	
How can an investor evaluate the operations of a corporation?	Two measures that relate earnings to the amount that shareholders have invested are • Rate of return on assets • Rate of return on common shareholders' equity For a healthy company, return on common shareholders' equity should exceed return on assets.
Accounting for Income Tax	
What are the three main accounts?	• Income tax expense • Income tax payable, a current liability • Future income tax asset or liability, a current or long-term asset or liability
How does a company measure	
• Income tax expense?	Income before income tax (from the income statement) × Income tax rate
• Income tax payable?	Taxable income (from the income tax return filed with Canada Revenue Agency) × Income tax rate
• Future income tax asset or liability?	Difference between income tax expense and income tax payable for any one year

Summary Problems for Your Review

1. Use the following accounts and related balances to prepare the classified balance sheet of Skeena Outfitters Ltd. at September 30, 2005. Use the account format of the balance sheet.

Common shares, 50,000 shares authorized, 20,000 shares issued	$125,000	Inventory	$ 85,000
Dividends payable	4,000	Property, plant, and equipment, net	225,000
Cash	9,000	Accounts receivable, net	25,000
Accounts payable	28,000	Preferred shares, $0.75, 10,000 shares authorized, 2,000 shares issued	24,000
Retained earnings	87,000	Accrued liabilities	3,000
Organization cost, net	1,000		
Long-term note payable	74,000		

2. The balance sheet of Cardoza Ltd. reported shareholders' equity (as shown on the next page) at March 31, 2005, the end of its fiscal year.

Required

a. Are the preferred shares cumulative or noncumulative? How can you tell?
b. What is the total amount of the annual preferred dividend?
c. Assume the common shares were all issued at the same time. What was the selling price per share?

d. Compute the book value per share of the preferred shares and the common shares. No prior year preferred dividends are in arrears, but Cardoza Ltd. has not declared the current-year dividend.

Shareholders' Equity	
Contributed capital:	
Preferred shares, $4.00, cumulative, 4,000 shares authorized and issued	$ 220,000
Common shares, 100,000 shares authorized, 50,000 shares issued	963,000
Total contributed capital	1,183,000
Retained earnings	770,000
Total shareholders' equity	$1,953,000

Solutions

1.

SKEENA OUTFITTERS LTD.
Balance Sheet
September 30, 2005

Assets		Liabilities		
Current:		Current:		
Cash	$ 9,000	Accounts payable		$ 28,000
Accounts receivable, net	25,000	Dividends payable		4,000
Inventory	85,000	Accrued liabilities		3,000
Total current assets	119,000	Total current liabilities		35,000
Capital assets, net	225,000	Long-term note payable		74,000
Intangible assets:		Total liabilities		109,000
Organization cost, net	1,000	**Shareholders' Equity**		
		Contributed capital:		
		Preferred shares, $0.75, 10,000 shares authorized, 2,000 shares issued	$ 24,000	
		Common shares, 50,000 shares authorized, 20,000 shares issued	125,000	
		Total contributed capital	149,000	
		Retained earnings	87,000	
		Total shareholders' equity		236,000
		Total liabilities and		
Total assets	$345,000	shareholders' equity		$345,000

2. Answers to Cardoza Ltd. questions:

a. The preferred shares are cumulative as is noted in their description.
b. Total annual preferred dividend: $16,000 (4,000 × $4.00)
c. Price per share: $19.26 ($963,000/50,000 shares issued)
d. Book values per share of preferred and common shares:

Preferred	
Book value	$220,000
Cumulative dividend for current year (4,000 × $4.00)	16,000
Shareholders' equity allocated to preferred	$236,000
Book value per share ($236,000/4,000 shares)	$ 59.00

Common	
Total shareholders' equity	$1,953,000
Less: Shareholders' equity allocated to preferred	236,000
Shareholders' equity available for common shareholders	$1,717,000
Book value per share ($1,717,000/50,000 shares)	$ 34.34

Cyber Coach

Visit the Study Guide on the Media Companion CD-ROM and the Student Resources area of the *Accounting* Companion Website for extra practice with the new material in Chapter 13.

www.pearsoned.ca/horngren

Summary

1. **Identify the characteristics of a corporation.** A corporation is a separate legal and business entity. Continuous life, the ease of raising large amounts of capital and transferring ownership, and limited liability are among the advantages of the corporate form of organization. An important disadvantage is a degree of double taxation. Corporations pay income taxes, and shareholders pay tax on dividends. Shareholders are the owners of a corporation. They elect a board of directors, which elects a chairperson and appoints the officers to manage the business.
2. **Record the issuance of shares.** Corporations may issue different classes of common and preferred shares.
3. **Prepare the shareholders' equity section of a corporation's balance sheet.** The balance sheet carries the capital raised through share issuance under the heading Contributed Capital in the shareholders' equity section. Donated assets, such as land, are reported under the heading Contributed Surplus—Donated Capital. Retained Earnings are listed last.
4. **Account for cash dividends.** Only when the board of directors declares a dividend does the corporation incur the liability to pay dividends. Preferred shares have priority over common shares as to dividends, which are stated as a dollar amount per share. In addition, preferred shares have a claim to dividends in arrears if they are cumulative. Convertible preferred shares may be exchanged for the corporation's common shares.
5. **Use different share values in decision making.** A share's *market value* is the price for which a share may be bought or sold. *Book value*—the amount of shareholders' equity per share—is another value that may apply to shares.
6. **Evaluate a company's return on assets and return on shareholders' equity.** *Return on assets* and *return on shareholders' equity* are two standard measures of profitability. A healthy company's return on equity will exceed its return on assets.
7. **Account for a corporation's income tax.** Corporations pay income tax and must account for the income tax expense and income tax payable. A difference between the expense and the payable creates other accounts, Future Income Tax Assets or Future Income Tax Liabilities.

Self-Study Questions

Test your understanding of the chapter by marking the best answer for each of the following questions:

1. Which of the following is a *disadvantage* of the corporate form of business organization? *(pp. 701–702)*
   a. Limited liability of shareholders
   b. Double taxation
   c. No mutual agency
   d. Transferability of ownership
2. The person with the most power in a corporation is the *(p. 703)*
   a. Accountant
   b. Chairperson of the board
   c. President
   d. Vice-president
3. The dollar amount of the shareholder investments in a corporation is called *(p. 705)*
   a. Outstanding shares
   b. Total shareholders' equity
   c. Contributed capital
   d. Retained earnings
4. The arbitrary value assigned to a share by the board of directors is called *(p. 709)*
   a. Market value
   b. Liquidation value
   c. Book value
   d. Stated value

5. Shares issued by a corporation incorporated under the *Canada Business Corporations Act* normally have *(p. 709)*
   a. No par value
   b. A par value set by management
   c. A par value set by the government
   d. A par value of $10.00

6. Mangum Corporation receives a building for 1,000 common shares. The building's book value is $385,000 and its current market value is $640,000. This transaction increases Mangum's share capital by *(p. 713)*
   a. $0 because the corporation received no cash
   b. $100,000
   c. $385,000
   d. $640,000

7. Organization cost is classified as a (an) *(p. 714)*
   a. Operating expense
   b. Current asset
   c. Contra item in shareholders' equity
   d. None of the above

8. Trade Days Inc. has 10,000 $3.50 cumulative preferred shares and 100,000 common shares issued and outstanding. Two years' preferred dividends are in arrears. Trade Days Inc. declares a cash dividend large enough to pay the preferred dividends in arrears, the preferred dividend for the current period, and a $1.50 dividend per common share. What is the total amount of the dividend? *(p. 720)*
   a. $255,000
   b. $220,000
   c. $150,000
   d. $105,000

9. The preferred shares of Trade Days Inc. in the preceding question were issued at $55 per share. Each preferred share can be converted into ten common shares. The entry to record the conversion of these preferred shares into common is *(p. 721)*

a. Cash	550,000	
Preferred Shares		500,000
Common Shares		50,000
b. Preferred Shares	500,000	
Cash	50,000	
Common Shares		550,000
c. Preferred Shares	550,000	
Common Shares		550,000
d. Common Shares	550,000	
Preferred Shares		550,000

10. When an investor is buying shares as an investment, the value of most direct concern is *(p. 722)*
    a. Par value
    b. Market value
    c. Liquidation value
    d. Book value

Answers to the Self-Study Questions follow the Similar Accounting Terms.

Accounting Vocabulary

Articles of incorporation *(p. 701)*
Authorization of shares *(p. 703)*
Board of directors *(p. 703)*
Book value *(p. 723)*
Bylaws *(p. 703)*
Chairperson (of board) *(p. 703)*
Common shares *(p. 705)*
Contributed capital *(p. 705)*
Convertible preferred shares *(p. 721)*
Cumulative preferred shares *(p. 720)*
Deficit *(p. 706)*
Dividends *(p. 706)*
Donated capital *(p. 713)*
Double taxation *(p. 702)*
Future income tax asset *(p. 727)*
Future income tax liability *(p. 728)*
Limited liability *(p. 702)*
Market value *(p. 722)*
No-par-value shares *(p. 709)*
Organization cost *(p. 715)*
Outstanding shares *(p. 704)*
Preferred shares *(p. 708)*
President *(p. 703)*
Pretax accounting income *(p. 726)*
Rate of return on common shareholders' equity *(p. 725)*
Rate of return on total assets *(p. 724)*
Retained earnings *(p. 705)*
Return on assets *(p. 724)*
Return on equity *(p. 725)*
Shareholder *(p. 701)*
Shareholders' equity *(p. 705)*
Shares *(p. 702)*
Stated value *(p. 709)*
Stock *(p. 702)*
Taxable income *(p. 726)*
Temporary difference *(p. 727)*
Timing difference *(p. 727)*

Similar Accounting Terms

Share capital	Capital stock
Donated capital	Contributed surplus
Shareholder	Stockholder
Stated capital	Share capital
Temporary difference	Timing difference

Answers to Self-Study Questions

1. b
2. b
3. c
4. d
5. a
6. d
7. d Intangible asset
8. a [(10,000 × $3.50 × 3 = $105,000) + (100,000 × $1.50 = $150,000) = $255,000]
9. c
10. b

Assignment Material

Questions

1. Identify the characteristics of a corporation.
2. Explain how corporate earnings are subject to double taxation.
3. Briefly outline the steps in the organization of a corporation.
4. Compare the characteristics of a partnership and a corporation.
5. Name the four rights of a shareholder. Are preferred shares automatically nonvoting?
6. Which event increases the assets of the corporation: authorization of shares or issuance of shares? Explain.
7. Suppose Ontzinc Ltd. issued 1,200 shares of its $4.50 preferred shares for $100 per share. How much would this transaction increase the company's contributed capital? How much would it increase retained earnings? How much would it increase annual cash dividend payments?
8. Red Deer Inc. issued 150 common shares for $8.00 per share and 250 shares for $9.50 per share. What would be the journal entry to record the combined issue?
9. How does issuance of 1,500 common shares for land and a building, together worth $200,000, affect contributed capital?
10. What is donated capital? Give an example of a transaction that creates donated capital for a corporation.
11. Journalize the incorporation of the Nixon & Garner partnership.
12. Rank the following accounts in the order in which they would appear on the balance sheet: Common Shares, Organization Cost, Contributed Surplus—Donated Capital, Preferred Shares, Retained Earnings, Dividends Payable. Also, give each account's balance sheet classification.
13. What type of account is Organization Cost? Briefly describe how to account for organization cost.
14. Briefly discuss the three important dates for a dividend.
15. Bassagio Inc. has 2,500 shares of its $1.75 preferred shares outstanding. Dividends for 2004 and 2005 are in arrears, and the company has declared no dividends on preferred shares for the current year, 2006. Assume that Bassagio Inc. declares total dividends of $25,000 at the end of 2006. Show how to allocate the dividends to preferred and common (a) if preferred is cumulative, and (b) if preferred is noncumulative.
16. As a preferred shareholder, would you rather own cumulative or noncumulative preferred? If all other factors are the same, would the corporation rather the preferred shares be cumulative or noncumulative? Give your reason.
17. How are cumulative preferred dividends in arrears reported in the financial statements? When do dividends become a liability of the corporation?
18. Distinguish between the market value of shares and the book value of shares. Which is more important to investors?
19. How is book value per common share computed when the company has both preferred shares and common shares outstanding?
20. Why should a healthy company's rate of return on shareholders' equity exceed its rate of return on total assets?
21. Explain the difference between a corporation's income tax expense and income tax payable.

Exercises

Exercise 13-1 *Characteristics of a corporation* ***(Obj. 1)***

Suppose you are forming a business and you need some outside money from other investors. Assume you have decided to organize the business as a corporation that will issue shares to raise the needed funds. Briefly discuss your most important reason for organizing as a corporation rather than as a partnership. If you had decided to organize as a partnership, what would be your most important reason for not organizing as a corporation?

Exercise 13-2 *Organizing a corporation* ***(Obj. 1)***

Anita Jones and Lars Johansen are opening a decorating business to be named J&J Decor Ltd. They need outside capital, so they plan to organize the business as a corporation. Because your office is in the same building, they come to you for advice. Write a memorandum informing them of the steps in forming a corporation. Identify specific documents used in this process, and name the different parties involved in the ownership and management of a corporation.

Exercise 13-3 *Issuing shares* ***(Obj. 2)***

Software Ltd. made the following share issuance transactions:

Jan.	19	Issued 4,000 common shares for cash of $20.00 per share.
Feb.	3	Sold 1,000 $3.00 Class A preferred shares for $25,000 cash.
	11	Received inventory valued at $49,000 and equipment with market value of $30,000 for 5,800 common shares.
	15	Issued 2,000 $2.00 Class B preferred shares with a stated value of $26 per share.

Required

1. Journalize the transactions. Explanations are not required.
2. How much contributed capital did these transactions generate for Software Ltd?

Exercise 13-4 *Issuing shares and preparing the shareholders' equity section of the balance sheet* ***(Obj. 2, 3)***

The articles of incorporation for On Point Consulting Inc. authorize the company to issue 500,000 $3 preferred shares and 1,000,000 common shares. During its start-up phase, On Point Consulting Inc. completed the following transactions:

2005		
July	4	Issued 5,000 common shares to the consultants who organized the corporation, receiving cash of $50,000.
	13	Issued 500 preferred shares for cash of $30,000.
	14	Issued 4,000 common shares in exchange for land valued at $48,000.
	31	Earned a profit for the fiscal year and closed the $25,000 net income into Retained Earnings.

Required

1. Record the transactions in the general journal.
2. Prepare the shareholders' equity section of the On Point Consulting Inc. balance sheet at July 31, 2005.

Exercise 13-5 *Recording issuance of shares* ***(Obj. 2)***

The balance sheet of BCE Inc. at December 31, 2002, reported the adapted Summary of First Preferred Shares shown on the next page. BCE Inc. has six issued and outstanding classes of preferred shares labelled as First Preferred Series.

Summary of First Preferred Shares (adapted)

Series	Authorized	Issued	Stated Capital
R	8,000,000	8,000,000	$200,000,000
S	8,000,000	8,000,000	200,000,000
U	22,000,000	14,000,000	350,000,000
Y	10,000,000	1,147,380	29,000,000
Z	10,000,000	8,852,620	221,315,500
AA	20,000,000	20,000,000	510,000,000

Common shares, authorized an unlimited number of shares

Outstanding	
915,867,928 shares	$16,520,000,000

The Series Z preferred shares were issued for $25.00 per share in 2002. In 2002, 12,000,000 Series W preferred shares (stated capital $300,000,000) were exchanged for 12,000,000 Series AA preferred shares. The remaining 8,000,000 Series AA were issued through a public bought deal offering.

Required

1. What was the average price at which the common shares were issued?
2. Make a journal entry to record the issuance of the Series Z and Series AA preferred shares.

Exercise 13-6 *Recording issuance of common shares* ***(Obj. 2)***

Montpelier Supplies Ltd., located in Thornbury, Ontario, imports farm equipment. The corporation issues 20,000 common shares for $12 per share. Record issuance of the shares.

Exercise 13-7 *Issuing shares to finance the purchase of assets* ***(Obj. 2)***

This exercise shows the similarity and the difference between two ways to acquire capital assets.

Case A—Issue shares and buy the assets in separate transactions:

Boulder Pass Equipment Ltd. issued 7,000 common shares for cash of $770,000. In a separate transaction, Boulder Pass then used the cash to purchase an office building for $500,000 and equipment for $270,000. Journalize the two transactions.

Case B—Issue shares to acquire the assets:

Boulder Pass Equipment Ltd. issued 7,000 common shares to acquire an office building valued at $500,000 and equipment worth $270,000. Journalize this transaction.

Compare the balances in all accounts after making both sets of entries. Are the account balances similar or different?

Exercise 13-8 *Contributed capital for a corporation* ***(Obj. 2)***

JMW Corp. has recently organized. The company issued common shares to a lawyer who provided legal services worth $20,000 to help organize the corporation. It issued common shares to another person in exchange for his patent with a market value of $75,000. In addition, JMW Corp. received cash both for 2,500 of its $2.50 preferred shares at $35 per share and for 27,500 of its common shares at $25 per share. The city of Peterborough donated 50 hectares of land to the company as a plant site. The market value of the land was $750,000. Without making journal entries, determine the total contributed capital created by these transactions.

Exercise 13-9 *Incorporating a partnership* **(Obj. 2)**

The Trenton Tornadoes are a semiprofessional basketball team that has been operated as a partnership by Sheila Mason and Tom Neilson. In addition to their management responsibilities, Neilson also plays for the team and Mason operates the concession. Journalize the following transactions in the first month of operation as a corporation:

June	14	The incorporators paid legal fees of $2,500 and other fees of $1,000 to obtain articles of incorporation.
	14	Issued 3,000 common shares to Mason and 2,200 common shares to Neilson. Mason's capital balance on the partnership books was $30,000, and Neilson's capital balance was $22,000.
	18	The city of Trenton donated 20 hectares of land to the corporation for a stadium site. The land's market value was $120,000.

Exercise 13-10 *Shareholders' equity section of a balance sheet* **(Obj. 3)**

The articles of incorporation for MOP Technology Inc. authorizes the issuance of 100,000 Class A preferred shares, 50,000 Class B preferred shares, and 250,000 common shares. During a two-month period, MOP Technology Inc. completed these share-issuance transactions:

Mar.	23	Issued 12,000 common shares for cash of $18.00 per share.
Apr.	2	Sold 1,500 $1.50 Class A preferred shares for $30,000 cash.
	12	Received inventory valued at $75,000 and equipment with market value of $30,000 for 5,000 common shares.
	17	Issued 1,500 $1.75 Class B preferred shares. The issue price was cash of $30 per share.

Required

1. Journalize the transactions, with explanations.
2. Prepare the shareholders' equity section of the MOP Technology Inc. balance sheet for the transactions given in this exercise. Retained Earnings has a balance of $60,000.



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Exercise 13-11 *Shareholders' equity section of a balance sheet* **(Obj. 3)**

Percival Corporation has the following selected account balances at June 30, 2005. Prepare the shareholders' equity section of the company's balance sheet.

Common shares, 500,000 shares authorized, 175,000 shares issued	$175,000	Inventory	$115,000
Donated capital	150,000	Machinery and equipment	140,000
Accumulated amortization—machinery and equipment	55,000	Preferred shares, $1.25, 100,000 shares authorized, 10,000 shares issued	150,000
Retained earnings	145,000	Organization cost, net	5,000
		Cost of goods sold	75,000

Exercise 13-12 *Dividing cash dividends between preferred and common shares* **(Obj. 4)**

Refer to the shareholders' equity of Envoy Corporation in Exhibit 13-6, page 715. Answer these questions about Envoy's dividends.

1. How much in dividends must Envoy Corporation declare each year before the common shareholders receive cash dividends for the year?
2. Suppose Envoy Corporation declares cash dividends of $10,000 for 2005. How much of the dividends go to preferred shareholders? How much goes to common shareholders?
3. Are Envoy Corporation's preferred shares cumulative or noncumulative? How can you tell?

4. Suppose Envoy Corporation did not pay the preferred dividend in 2005 and 2006. In 2007, Envoy declares cash dividends of $10,000. How much of the dividends go to preferred? How much goes to common?

Exercise 13-13 *Computing dividends on preferred and common shares* ***(Obj. 4)***

The following elements of shareholders' equity are adapted from the balance sheet of Morrison Marketing Ltd. All dollar amounts, except the dividends per share, are given in thousands.

Shareholders' Equity	
Preferred shares, cumulative (note 7)	
Series A, 100,000 shares authorized, 60,000 shares issued	$ 30
Series B, 750,000 shares authorized, 400,000 shares issued	400
Common shares, 2,000,000 shares authorized, 200,000 shares issued	2,000

Note 7: Preferred shares:

	Designated Annual Cash Dividend Per Share
Series A	$0.15
Series B	0.20

The Series A preferred has preference over Series B preferred, and the company has paid all dividends through 2003.

Required

Compute the dividends to both series of preferred and to common shareholders for 2004 and 2005 if total dividends are $18,000 in 2004 and $225,000 in 2005. Round to the nearest dollar.

Exercise 13-14 *Book value per share of preferred and common shares* ***(Obj. 5)***

The balance sheet of ARC Technology Inc. reported the following:

Cumulative preferred shares; 200 shares issued, liquidation value $15,000	$ 15,000
Common shares; 20,000 shares issued	300,000

Assume that ARC had paid preferred dividends for the current year and all prior years (no dividends in arrears). Retained earnings was $180,000. Compute the book value per share of the preferred shares and the common shares.

Exercise 13-15 *Book value per share of preferred and common shares; preferred dividends in arrears* ***(Obj. 4, 5)***

Refer to Exercise 13-14. Compute the book value per share of the preferred shares and the common shares, assuming that three years' preferred dividends (including dividends for the current year) are in arrears. Assume the preferred shares are cumulative and their dividend rate is $2.50 per share.

Exercise 13-16 *Evaluating profitability* ***(Obj. 6)***

Deliveau Equipment Inc. reported the figures shown on the next page for 2005 and 2004.

Compute rate of return on total assets and rate of return on common shareholders' equity for 2005. Do these rates of return suggest strength or weakness? Give your reason.

	2005	2004
Income statement:		
Interest expense	$ 31,320,000	$ 22,100,000
Net income	19,500,000	31,600,000
Balance sheet:		
Total assets	631,800,000	571,000,000
Preferred shares, $1.15, 180,000 shares issued and outstanding	4,050,000	4,050,000
Common shareholders' equity	279,000,000	257,000,000
Total shareholders' equity	283,050,000	261,050,000

Exercise 13-17 *Accounting for income tax by a corporation* ***(Obj. 7)***

Mercury Transportation Inc. is taxed at the rate of 32 percent. Income before taxes was $200,000 for 2004. The company had neither future income tax assets nor liabilities at January 1, 2004. The following two situations are independent:

A. Mercury Transportation Inc. claimed $25,000 for warranty expense in 2004 in arriving at $200,000 income before taxes. The $25,000 was actually incurred in 2005.

B. Mercury Transportation Inc. purchased capital assets for $70,000 in 2004. The company claimed amortization of $5,000 in arriving at $200,000 income in 2004. Maximum capital cost allowance was $7,000 in 2004.

Required

For each of the two situations:

1. Decide whether Mercury Transportation Inc. has a future income tax asset or a future income tax liability.
2. Calculate the future income tax asset or liability at December 31, 2004.
3. Show the journal entries Mercury Transportation Inc. would make with respect to income taxes for 2004.

Challenge Exercise

Exercise 13-18 *Accounting for shareholders' equity transactions* ***(Obj. 2, 4)***

Warren Motors Inc. reported these comparative shareholders' equity data:

	December 31,	
	2005	2004
Common shares	$ 630,000	$150,000
Retained earnings	1,120,000	769,000

During 2005, Warren Motors Inc. completed these transactions and events:

a. Net income, $651,000.

b. Cash dividends, $300,000.

c. Issuance of common shares for cash, 1,500 shares at $20 per share.

d. Issuance of common shares to purchase another company (Warren Motors debited the Investments account), 15,000 shares at $30 per share.

Required

Without making journal entries, show how Warren Motors Inc.'s 2005 transactions and events accounted for the changes in the shareholders' equity accounts. For each shareholders' equity account, start with the December 31, 2004, balance and work toward the balance at December 31, 2005.

Beyond the Numbers

Beyond the Numbers 13–1 *Characteristics of corporations' shareholders' equity* ***(Obj. 2, 5)***

Answering the following questions will enhance your understanding of the shareholders' equity of corporations.

1. Why do you think contributed capital and retained earnings are shown separately in the shareholders' equity section?
2. Lucy Lang, major shareholder of L-L Inc., proposes to sell some land she owns to the company for common shares in L-L Inc. What problem does L-L Inc. face in recording the transaction?
3. Preferred shares generally are preferred with respect to dividends and on liquidation. Why would investors buy common shares when preferred shares are available?
4. If you owned 100 shares of Cara Corporation and someone offered to buy the shares for their book value, would you accept the offer? Why or why not?
5. What is a convertible preferred share? Why would an investor exercise the conversion privilege?

Ethical Issue

Note: This case is based on a real situation.

Jason Chad paid $50,000 for a franchise that entitled him to market Success Associates software programs in the countries of the European Union. Chad intended to sell individual franchises for the major language groups of western Europe—German, French, English, Spanish, and Italian. Naturally, investors considering buying a franchise from Chad asked to see the financial statements of his business.

Believing the value of the franchise to be greater than $50,000, Chad sought to capitalize his own franchise at $500,000. The law firm of St. Charles and LaDue helped Chad form a corporation authorized to issue 500,000 common shares. Lawyers suggested the following chain of transactions:

1. A third party borrows $500,000 and purchases the franchise from Chad.
2. Chad pays the corporation $500,000 to acquire all of its shares.
3. The corporation buys the franchise from the third party, who repays the loan.

In the final analysis, the third party is debt-free and out of the picture. Chad owns all the corporation's shares, and the corporation owns the franchise. The corporation balance sheet lists a franchise acquired at a cost of $500,000. This balance sheet is Chad's most valuable marketing tool.

Required

1. What is unethical about this situation?
2. Who can be harmed? How can they be harmed? What role does accounting play?

Problems (Group A)

Problem 13-1A *Organizing a corporation* ***(Obj. 1)***

John Keller and Brigid Johannsen are opening an office supply store in a shopping centre in Cowansville, Quebec. The area is growing, and no competitors are located in the immediate vicinity. Their most fundamental decision is how to organize

the business. Keller thinks the partnership form is best. Johannsen favours the corporate form of organization. They seek your advice.

Required

Write a memo to Keller and Johannsen to make them aware of the advantages and disadvantages of organizing the business as a corporation. Use the following format for your memo:

Date:	_____
To:	John Keller and Brigid Johannsen
From:	Student Name
Subject:	Advantages and disadvantages of the corporate form of business organization

Problem 13-2A *Journalizing corporation transactions and preparing the shareholders' equity section of the balance sheet* ***(Obj. 2, 3)***

The partners who own Armstrong & Russell wished to avoid the unlimited personal liability of the partnership form of business, so they incorporated the partnership as Software Solutions Ltd. The articles of incorporation from the federal government authorize the corporation to issue 100,000 $5.00 preferred shares and 250,000 common shares. In its first month, Software Solutions Ltd. completed the following transactions:

2004

Jan. 2 Paid incorporation costs of $2,500 and legal fees of $10,000 to organize as a corporation.

6 Issued 11,100 common shares to J. Armstrong and 7,900 shares to S. Russell in return for the net assets of the partnership. Armstrong's capital balance on the partnership books was $111,000, and Russell's capital balance was $79,000.

12 Issued 100 preferred shares to acquire software with a market value of $25,000.

22 Issued 5,000 common shares for $13 cash per share.

Required

1. Record the transactions in the general journal.
2. Prepare the shareholders' equity section of the Software Solutions Ltd. balance sheet at December 31, 2004. The ending Retained Earnings balance is $60,000.

Problem 13-3A *Issuing shares and preparing the shareholders' equity section of the balance sheet* ***(Obj. 2, 3)***

Golden Triangle Corporation was organized in 2004. At December 31, 2004, Golden Triangle Corporation's balance sheet reported the following shareholders' equity:

Preferred shares, $0.35, 50,000 shares authorized, none issued	$ —
Common shares, 100,000 shares authorized, 10,000 shares issued	125,000
Retained earnings (Deficit)	(15,000)
Total shareholders' equity	$ 110,000

Required

1. What does the $0.35 mean for the preferred shares? After Golden Triangle Corporation issues preferred shares, how much in cash dividends will Golden Triangle Corporation expect to pay on 2,000 shares?

2. At what price per share did Golden Triangle Corporation issue the common shares during 2004?
3. Were first-year operations profitable? Give your reason.
4. During 2005, the company completed the following selected transactions. Journalize each transaction. Explanations are not required.
   a. Issued for cash 10,000 preferred shares at $4 per share.
   b. Issued for cash 1,000 common shares at a price of $15 per share.
   c. Issued 25,000 common shares to acquire a building valued at $375,000.
   d. Net income for the year was $75,000, and the company declared no dividends. Make the closing entry for net income.
5. Prepare the shareholders' equity section of the Golden Triangle Corporation balance sheet at December 31, 2005.

Problem 13-4A *Shareholders' equity section of the balance sheet* ***(Obj. 3)***


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Shareholders' equity information is given for Aquarium Inc. and Plaza Corp. The two companies are independent.

Aquarium Inc. Aquarium Inc. is authorized to issue 100,000 common shares. All the shares were issued at $15 per share. The company incurred a net loss of $45,000 in 2003, its first year of business. It earned net income of $50,000 in 2004 and $75,000 in 2005. The company declared no dividends during the three-year period.

Plaza Corp. Plaza Corp.'s articles of incorporation authorize the company to issue 50,000 $2.25 cumulative preferred shares and 500,000 common shares. Plaza Corp. issued 3,000 preferred shares at $25 per share. It issued 50,000 common shares for a total of $250,000. The company's retained earnings balance at the beginning of 2005 was $150,000 and net income for the year was $100,000. During 2005, the company declared the specified dividend on preferred and a $0.75 per share dividend on common. Preferred dividends for 2004 were in arrears.

Required

For each company, prepare the shareholders' equity section of its balance sheet at December 31, 2005. Show the computation of all amounts. Journal entries are not required.

Problem 13-5A *Analyzing the shareholders' equity of an actual corporation* ***(Obj. 3, 4)***

The purpose of this problem is to familiarize you with the financial statement information of a real company, Domtar Inc. Domtar Inc. (www.domtar.com) included the following shareholders' equity on its year-end balance sheet at December 31, 2002:

Shareholders' Equity	($ millions)
Preferred shares, unlimited authorization:	
Series A—issued 69,576 shares	$ 2
Series B—issued 1,710,000 shares	42
Common shares, unlimited authorization, issued 227,680,352 shares	1,752
Retained earnings	753
	$2,549

Note: Series A preferred shares are non-voting and redeemable, and carry a cumulative cash dividend per share of $2.25 per annum.
Series B preferred shares are non-voting and redeemable, and carry a cumulative cash dividend equivalent to 72% of the bank prime rate.

Required

1. Identify the different issues of shares Domtar Inc. has outstanding.
2. Give the summary entries to record issuance of all the Domtar Inc. shares. Assume that all the shares were issued for cash. Explanations are not required.
3. What amount of preferred dividends must Domtar Inc. declare and pay each year to avoid having preferred dividends in arrears on the Series A shares?
4. Assume that Series A preferred dividends are in arrears for 2002.
   a. Write a note for the December 31, 2002, financial statements to disclose the dividends in arrears.
   b. Record the declaration of a dividend for Series A preferred shares in the year ended December 31, 2003, to pay the amount in arrears and the current-year dividend.

Problem 13-6A *Preparing a corporation balance sheet; measuring profitability* ***(Obj. 3, 6)***

Link Back to Chapter 1 (Accounting Equation) The following accounts and related balances of Blue Moon Systems Ltd. are arranged in no particular order.

Trademark, net	$ 19,000	Common shareholders' equity, June 30, 2004	$400,000
Preferred shares, $0.40, 10,000 shares authorized and issued	59,000	Net income	50,000
Cash	30,000	Total assets, June 30, 2004	820,000
Accounts receivable, net	105,000	Interest expense	14,400
Accrued liabilities	60,000	Property, plant, and equipment, net	600,000
Long-term note payable	97,000	Common shares, 500,000 shares authorized; 272,000 shares issued	600,000
Inventory	187,000	Prepaid expenses	24,000
Dividends payable	21,000		
Retained earnings	?		
Accounts payable	72,000		

Required

1. Prepare the company's classified balance sheet in the report format at June 30, 2005.
2. Compute rate of return on total assets and rate of return on common shareholders' equity for the year ended June 30, 2005.
3. Do these rates of return suggest strength or weakness? Give your reason.


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Problem 13-7A *Computing dividends on preferred and common shares* ***(Obj. 4)***

WHZ Broadcasting Inc. has 10,000 $4.50 preferred shares and 50,000 common shares outstanding. WHZ Broadcasting Inc. declared and paid the following dividends during a three-year period: 2003, $40,000; 2004, $90,000; and 2005, $200,000.

Required

1. Compute the total dividends on preferred shares and common shares for each of the three years if
   a. Preferred is noncumulative.
   b. Preferred is cumulative.
2. For requirement 1b, record the declaration of the 2005 dividends on December 28, 2005, and the payment of the dividends on January 17, 2006.

Problem 13-8A *Analyzing the shareholders' equity of a corporation* ***(Obj. 4, 5)***

The balance sheet of Bartlett Sales Company Limited reported the following at December 31, 2004:

Shareholders' Equity	
Redeemable non-voting cumulative preferred shares, authorized 20,000 shares (liquidation value $700,000)	$ 650,000
Common shares, authorized 200,000 shares; issued 90,000 shares	637,000
Retained earnings	190,000
Total shareholders' equity	$1,477,000

Notes to the financial statements indicate that 16,000 $2.50 preferred shares were issued and outstanding. Preferred dividends have not been paid for three years, including the current year. On the balance sheet date, the market value of the Bartlett Sales Company Limited's common shares was $7.00 per share.

Required

1. Are the preferred shares cumulative or noncumulative? How can you tell?
2. What is the amount of the annual preferred dividend?
3. Which class of shareholders controls the company? Give your reason.
4. What is the total contributed capital of the company?
5. What was the total market value of the common shares?
6. Compute the book value per share of the preferred shares and the common shares.

Problem 13-9A *Computing and recording a corporation's income tax* ***(Obj. 7)***

The accounting (not for income tax) records of Big Bear Manufacturing Inc. provide the income statement for 2005:

	2005
Total revenue	$1,800,000
Expenses:	
Cost of goods sold	$ 750,000
Operating expenses	490,000
Total expenses (before tax)	1,240,000
Pretax accounting income	$ 560,000

Revenue for 2006 will include rent of $40,000 that was received late in 2005. This rent will be included in 2006 total revenue because the rent will be earned in 2006. However, rent revenue that is collected in advance is included in taxable income when the cash is received. In calculating taxable income on the tax return, this rent revenue belongs in 2005.

Big Bear Manufacturing Inc. calculates amortization of capital assets for accounting purposes at the maximum rate allowed by Canada Revenue Agency. Therefore, amortization and capital cost allowance for 2005 was $50,000.

Required

(Assume a corporate income tax rate of 32 percent.)

1. Compute taxable income for 2005.
2. Journalize the corporation's income taxes for 2005.
3. Prepare the corporation's single-step income statement for 2005.

Problem 13-10A *Accounting for the incorporation of an ongoing business; recording the issuance of shares; allocating cash dividends; preparing the shareholders' equity section of the balance sheet* ***(Obj. 2, 3, 4)***

Shatel Moran and Louis Odette are partners in a business that imports Oriental rugs. The capital account balances are $80,000 and $115,000. They are considering

incorporating and taking advantage of an offer from the city of Moncton to establish a new showroom. The following transactions then took place:

2003		
Jan.	2	Moran and Odette incorporated their partnership into Flying Carpets Corporation, with an authorization to issue 100,000 $0.50 convertible preferred shares and 500,000 common shares. Moran received 40,000 common shares and Odette received 57,500 common shares.
	9	The city of Moncton donated land to the new corporation in exchange for opening its showroom in that area. The land had cost the city $80,000 when purchased 10 years earlier, but had a market value currently of $150,000.
	15	Paid $3,000 and gave 4,000 common shares to the corporation's legal firm for incorporating the business. The total legal fee was $8,000.
Mar.	5	Sold 4,000 preferred shares for $24,000. The preferred shares are convertible on the basis of 2 common shares for each preferred share.
Dec.	31	The company reported net income after taxes of $90,000 for the year, and then closed the income summary account.
2004		
Feb.	12	Declared cash dividends of $15,000, payable on April 8, 2004, to the shareholders of record on March 1, 2004. Indicate the amount that would be payable to the preferred and to the common shareholders.
Apr.	8	Paid the cash dividend declared on February 12, 2004.
July	7	The preferred shareholders converted 1,000 preferred shares into common shares.
Dec.	31	The company reported net income after taxes of $110,000 for the year, and then closed the income summary account.
2005		
Feb.	16	Declared cash dividends of $60,000, payable on April 11, 2005, to the shareholders of record on March 13, 2005. Indicate the amount that would be payable to the preferred and to the common shareholders.

Required

1. Record the transactions in the general journal.
2. Prepare the shareholders' equity section of the balance sheet as of the close of business on February 16, 2005.

Problem 13-11A *Recording the issuance of shares; allocating cash dividends; accounting for corporate income taxes; preparing the liability and shareholders' equity sections of the balance sheet* ***(Obj. 2, 3, 4, 7)***

At January 1, 2004, Techster Ltd.'s balance sheet reported the following shareholders' equity:

Shareholders' Equity

Contributed capital:	
Preferred shares, $1.50, cumulative (3 years in arrears), liquidation price of $50, 100,000 shares authorized, 30,000 shares issued	$ 900,000
Common shares,	
Class A, 15,000 shares authorized and issued	150,000
Class B, unlimited number of shares authorized, 75,000 shares issued	500,000
Total preferred and common shares	1,550,000
Contributed surplus—Donated capital	250,000
Total contributed capital	1,800,000
Retained earnings	500,000
Total shareholders' equity	$2,300,000

The company had the following transactions on the dates indicated:

2004

Dec. 1 The company declared dividends of $250,000, payable on January 14, 2005, to the shareholders of record on December 31, 2004. Indicate the amount that would be payable to the preferred shareholders and to the common shareholders. The dividend rate for Class A and Class B shares is the same.

31 The company reported pretax accounting income of $150,000 and taxable income of $120,000 (income tax rate = 30 percent). Record the income taxes and close the income summary account.

2005

Jan. 7 The company sold 10,000 preferred shares at $35 per share.

14 The company paid the dividend declared on December 1, 2004.

Feb. 14 The company sold 15,000 Class B common shares at $10 per share.

Apr. 15 The company paid the income taxes payable from 2004.

Dec. 2 The company declared dividends of $100,000, payable on January 13, 2006, to the shareholders of record on December 31, 2005. Indicate the amount that would be payable to the preferred shareholders and to the common shareholders.

31 The company reported pretax accounting income of $130,000 and taxable income of $110,000 (income tax rate = 30 percent). Record the income taxes and close the income summary account.

2006

Jan. 13 Paid the dividend declared on December 2, 2005.

Required

1. Record the transactions in the general journal.
2. Prepare the liability and shareholders' equity sections of the balance sheet as of the close of business on March 31, 2006. Assume no other transactions occurred after January 13, 2006.
3. Calculate the book value per share of the preferred shares and of the common shares on March 31, 2006.
4. What was the average price at which the Class A common shares were sold?

Problems (Group B)

Problem 13-1B *Organizing a corporation* ***(Obj. 1)***

Bob Falkner and Carol Kinishita are opening a software company in a growing section of Aurora, Ontario. They have developed a new and effective software to manage small business operations. Their most fundamental decision is how to organize the business. Falkner thinks the partnership form is best. Kinishita favours the corporate form of organization. They seek your advice.

Required

Write a memo to Falkner and Kinishita to make them aware of the advantages and the disadvantages of organizing the business as a corporation. Use the following format for your memo:

Date:	_____
To:	Bob Falkner and Carol Kinishita
From:	Student Name
Subject:	Advantages and disadvantages of the corporate form of business organization

Problem 13-2B *Journalizing corporation transactions and preparing the shareholders' equity section of the balance sheet* ***(Obj. 2, 3)***

The partnership of Tom Raynor and Nancy Norris needed additional capital to expand into new markets, so the business incorporated as Raynor Services Inc. The articles of incorporation under the *Canada Business Corporations Act* authorize Raynor Services Inc. to issue 300,000 $2.50 preferred shares and 2,000,000 common shares. In its first month, Raynor Services Inc. completed the following transactions:

2005		
August	2	Paid incorporation fees of $1,500 and paid legal fees of $12,000 to organize as a corporation.
	2	Issued 20,000 common shares to Raynor and 25,000 common shares to Norris in return for the net assets of the partnership. Raynor's capital balance on the partnership books was $70,000, and Norris's capital balance was $87,500.
	8	Received a parcel of land valued at $200,000 as a donation from the municipality in which the company is located.
	10	Issued 1,000 preferred shares to acquire a computer system with a market value of $35,000.
	16	Issued 15,000 common shares for cash of $85,000.

Required

1. Record the transactions in the general journal.
2. Prepare the shareholders' equity section of the Raynor Services Inc. balance sheet at December 31, 2005. The ending balance in Retained Earnings is $55,000.

Problem 13-3B *Issuing shares and preparing the shareholders' equity section of the balance sheet* ***(Obj. 2, 3)***

Marathon Inc. was organized in 2005. At December 31, 2005, Marathon Inc.'s balance sheet reported the following shareholders' equity:

Preferred shares, $4.00, 200,000 shares authorized, none issued	$ —
Common shares, 1,000,000 shares authorized, 150,000 shares issued	300,000
Retained earnings (Deficit)	(75,000)
Total shareholders' equity	$225,000

Required

Answer the following questions, making journal entries as needed.

1. What does the $4.00 mean for the preferred shares? After Marathon Inc. issues preferred shares, how much in cash dividends will Marathon Inc. expect to pay on 2,000 shares?
2. At what price per share did Marathon Inc. issue the common shares during 2005?
3. Were first-year operations profitable? Give your reason.
4. During 2006, the company completed the following selected transactions:
   a. Issued for cash 1,500 preferred shares at $40 per share.
   b. Issued for cash 5,000 common shares at a price of $2.25 per share.
   c. Issued 100,000 common shares to acquire a building valued at $250,000.
   d. Net income for the year was $150,000, and the company declared no dividends. Make the closing entry for net income.

   Journalize each transaction. Explanations are not required.
5. Prepare the shareholders' equity section of the Marathon Inc. balance sheet at December 31, 2006.

Problem 13-4B *Shareholders' equity section of the balance sheet* ***(Obj. 3)***

The following summaries for Mordevelopment Ltd. and Unique Products Inc. provide the information needed to prepare the shareholders' equity section of each company's balance sheet. The two companies are independent.

Mordevelopment Ltd. Mordevelopment Ltd. is authorized to issue 100,000 common shares. All the shares were issued at $5.00 per share. The company incurred net losses of $120,000 in 2002 (its first year of operations) and $40,000 in 2003. It earned net incomes of $50,000 in 2004 and $60,000 in 2005. The company declared no dividends during the four-year period.

Unique Products Inc. Unique Products Inc.'s articles of incorporation authorize the company to issue 100,000 cumulative preferred shares and 1,000,000 common shares. Unique Products Inc. issued 1,000 preferred shares at $25 per share. It issued 100,000 common shares for $400,000. The company's retained earnings balance at the beginning of 2005 was $75,000. Net income for 2005 was $50,000, and the company declared the specified preferred share dividend for 2005. Preferred share dividends for 2004 were in arrears. The preferred dividend was $2.00 per share per year.

Required

For each company, prepare the shareholders' equity section of its balance sheet at December 31, 2005. Show the computation of all amounts. Entries are not required.

Problem 13-5B *Analyzing the shareholders' equity of an actual corporation* ***(Obj. 3, 4)***

The purpose of this problem is to familiarize you with financial statement information. Inco Limited (www.inco.com) is one of the world's leading producers of nickel and an important producer of copper, precious metals, and cobalt. Inco Limited reported the following information in its December 31, 2002, annual report:

Shareholders' Equity (adapted)
(amounts in millions)

Preferred Series E	
Issued 9,439,600 shares	$ 472
Common shares	
Issued 183,238,351 shares	2,771
Contributed surplus	559
Retained earnings (Deficit)	(317)
Total shareholders' equity	$3,485

Note: Series E preferred shares are voting, redeemable, convertible, and carry a cumulative cash dividend per share of $2.75 per annum.

Required

1. Identify the different issues of shares Inco Limited has outstanding.
2. Explain the convertible characteristic of the preferred shares.
3. Suppose Inco Limited did not pay its preferred dividends for one year. Would the company have to pay these dividends in arrears before paying dividends to the common shareholders? Give your reason.
4. What amount of preferred dividends must Inco Limited declare and pay each year to avoid having preferred dividends in arrears?
5. Assume preferred dividends are in arrears for 2002.
   a. Write the note for the December 31, 2002, financial statements to disclose the dividends in arrears.

b. Journalize a declaration of a $75 million dividend for 2003. An explanation is not required.

Problem 13-6B *Preparing a corporation balance sheet; measuring profitability* ***(Obj. 3, 6)***

Link Back to Chapter 1 (Accounting Equation). The following accounts and related balances of Plaxo Manufacturing Inc. are arranged in no particular order.

Accounts payable	$ 72,000	Accrued liabilities	$ 46,000
Retained earnings	?	Long-term note payable	201,000
Common shares, 100,000 shares authorized, 33,000 shares issued	330,000	Accounts receivable, net	225,000
Dividends payable	9,000	Preferred shares, $0.30 25,000 shares authorized, 6,500 shares issued	65,000
Total assets, Nov. 30, 2004	1,135,000	Cash	70,000
Net income	81,500	Inventory	381,000
Common shareholders' equity, Nov. 30, 2004	1,040,000	Property, plant, and equipment, net	562,000
Interest expense	21,700	Prepaid expenses	31,000
		Patent, net	74,000

Required

1. Prepare the company's classified balance sheet in the report format at November 30, 2005.
2. Compute rate of return on total assets and rate of return on common shareholders' equity for the year ended November 30, 2005.
3. Do these rates of return suggest strength or weakness? Give your reason.


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Problem 13-7B *Computing dividends on preferred and common shares* ***(Obj. 4)***

Crescendo Corporation has 20,000 $0.50 preferred shares and 300,000 common shares outstanding. During a three-year period, Crescendo Corporation declared and paid cash dividends as follows: 2003, $6,000; 2004, $31,000; and 2005, $60,000.

Required

1. Compute the total dividends to preferred shares and common shares for each of the three years if
   a. Preferred is noncumulative.
   b. Preferred is cumulative.
2. For requirement 1b, record the declaration of the 2005 dividends on December 22, 2005, and the payment of the dividends on January 12, 2006.

Problem 13-8B *Analyzing the shareholders' equity of a corporation* ***(Obj. 4, 5)***

The balance sheet of Coppercreek Systems Inc. reported the following:

Shareholders' Equity	($ thousands)
Cumulative convertible preferred shares; authorized 25,000 shares	$ 75
Common shares, authorized 50,000 shares; issued 22,000 shares	220
Deficit	(70)
Total shareholders' equity	$225

Notes to the financial statements indicate that 10,000 $0.30 preferred shares were issued and outstanding. The preferred shares have a liquidation value of $5.00 per share. Preferred dividends are in arrears for two years, including the current year. On the balance sheet date, the market value of the Coppercreek Systems Inc. common shares was $8.10 per share.

Required

1. Are the preferred shares cumulative or noncumulative? How can you tell?
2. What is the amount of the annual preferred dividend?
3. What is the total contributed capital of the company?
4. What is the total market value of the common shares?
5. Compute the book value per share of the preferred shares and of the common shares.

Problem 13-9B *Computing and recording a corporation's income tax* ***(Obj. 7)***

The accounting (not the income tax) records of Great Solutions Inc. provide the income statement for 2005:

	2005
Total revenue	$1,500,000
Expenses:	
Cost of goods sold	$ 740,000
Operating expenses	560,000
Total expenses before tax	1,300,000
Pretax accounting income	$ 200,000

The company has unearned revenue of $100,000 at the end of 2005. For tax purposes, revenue that is collected in advance is included in the taxable income of the year when the cash is received. In calculating taxable income on the tax return, this revenue belongs in 2005.

Great Solutions Inc. calculates amortization of capital assets for accounting purposes at the maximum rate allowed by the *Income Tax Act*. Therefore, amortization and capital cost allowance for 2005 was $70,000.

Required

(Assume a corporate income tax rate of 35 percent.)

1. Compute taxable income for 2005.
2. Journalize the corporation's income taxes for 2005.
3. Prepare the corporation's single-step income statement for 2005.

Problem 13-10B *Accounting for the incorporation of an ongoing business; recording the issuance of shares; allocating cash dividends; preparing the shareholders' equity section of the balance sheet* ***(Obj. 2, 3, 4)***

Bob Marshall and Bill Wong are partners in a small tools business with capital account balances of $90,000 and $140,000 respectively. They are considering incorporating and taking advantage of an offer from the city of Kamloops to establish a new manufacturing plant. The following transactions then took place:

2004

Jan. 2 Marshall and Wong incorporated their partnership into MW Tools Inc. with an authorization to issue 100,000, $1.50 convertible preferred shares and 500,000 common shares. Marshall received 90,000 common shares and Wong received 140,000 common shares.

9 The city of Kamloops donated land to the new corporation in exchange for establishing the business in that area. The land had cost the city $50,000 when purchased 10 years ago, but has a market value today of $300,000.

17 Paid $5,000 and gave 5,000 common shares to the corporation's legal firm for incorporating the business. The total legal fee was $15,000.

Mar. 7 Sold 10,000 preferred shares for $30,000. The preferred shares are convertible on the basis of 3 common shares for each preferred share.

Dec. 31 The company reported net income after taxes of $100,000 for the year, and then closed the income summary account.

2005

Feb. 14 Declared cash dividends of $25,000, payable on April 11, 2005, to the shareholders of record on March 1, 2005. Indicate the amount that would be payable to the preferred and to the common shareholders.

Apr. 11 Paid the cash dividend declared on February 14, 2005.

Sept. 7 The preferred shareholders converted 2,000 preferred shares into common.

Dec. 31 The company reported net income after taxes of $136,000 for the year, and then closed the income summary account.

2006

Feb. 16 Declared cash dividends of $50,000, payable on April 10, 2006, to the shareholders of record on March 13, 2006. Indicate the amount that would be payable to the preferred and to the common shareholders.

Required

1. Record the transactions in the general journal.
2. Prepare the shareholders' equity section of the balance sheet as of the close of business on February 16, 2006.

Problem 13-11B *Recording the issuance of shares; allocating cash dividends; accounting for corporate income taxes; preparing the liability and shareholders' equity sections of the balance sheet* ***(Obj. 2, 3, 4, 7)***

At January 1, 2004, Edgewater Manufacturing Ltd.'s balance sheet reported the following shareholders' equity:

Shareholders' Equity

Contributed capital:	
Preferred shares, $2 cumulative (2 years in arrears), liquidation price of $55.00, 100,000 shares authorized, 10,000 shares issued	$ 600,000
Common shares:	
Class A, 40,000 shares authorized and issued	400,000
Class B, unlimited number of shares authorized, 100,000 shares issued	2,000,000
Total preferred and common shares	3,000,000
Contributed surplus—Donated capital	150,000
Total contributed capital	3,150,000
Retained earnings	600,000
Total shareholders' equity	$3,750,000

The company had the following transactions on the dates indicated:

2004

Dec. 1 The company declared dividends of $175,000, payable on January 15, 2005, to the shareholders of record on December 31, 2004. Indicate the amount that would be payable to the preferred shareholders and to the common shareholders. Class A and Class B shares receive the same per-share dividend.

31 The company reported pretax accounting income of $175,000 and taxable income of $150,000 (income tax rate = 40 percent). Record the income taxes and close the income summary account.

2005

Jan. 7 The company sold 5,000 preferred shares at $55 per share.

15 Paid the dividend declared on December 1, 2004.

Feb. 14 The company sold 10,000 Class B common shares at $15 per share.

Apr. 18 The company paid the income taxes payable from 2004.

Dec. 2 The company declared dividends of $180,000, payable on January 15, 2006, to the shareholders of record on December 31, 2005. Indicate the amount that would be payable to the preferred shareholders and to the common shareholders.

31 The company reported pretax accounting income of $350,000 and taxable income of $300,000 (income tax rate = 40 percent). Record the income taxes and close the income summary account.

2006

Jan. 15 Paid the dividend declared on December 2, 2005.

Required

1. Record the transactions in the general journal.
2. Prepare the liability and shareholders' equity sections of the balance sheet as of the close of business on December 31, 2005.
3. Calculate the book value per share of the preferred shares and of the common shares (Class A and Class B combined) on December 31, 2005.
4. What was the average price at which the Class A common shares were sold?

Challenge Problems

Problem 13-1C *The pros and cons of incorporation* ***(Obj. 1)***

Your friend Tessa Lee Bradshaw has come to you for advice. She has a very successful antique store that had sales of more than $520,000 in the year just ended. She would like to expand and will need to borrow $400,000 to finance an enlarged inventory. She has learned that she can buy the store adjoining hers for $280,000 and estimates that $60,000 of renovations would be needed to make the store compatible with her present store. Expansion would mean adding three or four employees to the two employees Tessa Lee already has.

Tessa Lee's accountant has suggested that she incorporate her business and that Tessa Lee hold all the shares. She cited several reasons to Tessa Lee, including the benefits of limited liability. Tessa Lee has talked to her banker about the possibility of incorporating; he pointed out that if she did incorporate, the bank would need personal guarantees for any loans Tessa Lee arranged with the bank.

Required

Consider Tessa Lee's situation and discuss the pros and cons of incorporation for Tessa Lee. What would you suggest?

Problem 13-2C *Deciding on an investment in shares* ***(Obj. 5, 6)***

You have just received a bequest from an aunt of $2,000 and you have decided to invest the money in shares of Sweet Games Inc., a company that develops software for video games and that is listed on the Toronto Stock Exchange. Sweet Games Inc. (SGI) has common shares; cumulative preferred shares; noncumulative, convertible preferred shares; and noncumulative preferred shares. The common shares are trading at $40.00 and currently have been paying a dividend of $2.40 per share. The cumulative preferred shares are selling at $50.00 and have a stated dividend of $3.50. The convertible preferred shares are selling for $78.50 and are convertible at the rate of 2 common for 1 preferred; the dividend rate is $5.30. The noncumulative preferred shares are trading at $25.00 and have a dividend rate of $1.55.

Required

Evaluate each of the four different shares as an investment opportunity. After performing your analysis, select which shares you will buy and explain your choice.

Extending Your Knowledge

Decision Problem

Evaluating alternative ways of raising capital (Obj. 2, 3)

Raylene Link and Samantha Chain have written a spreadsheet program (LinkChain) to rival Excel. They need additional capital to market the product, and they plan to incorporate the business. They are considering the capital structure. Their primary goal is to raise as much capital as possible without giving up control of the business. Link and Chain plan to sell the LinkChain software to the corporation in exchange for 100,000 common shares. The partners have been offered $100,000 for the software.

The corporation's plans for the articles of incorporation include an authorization to issue 10,000 preferred shares and 1,000,000 common shares. Link and Chain are uncertain about the most desirable features for the preferred shares. Prior to incorporating, the partners have discussed their plans with two investment groups. The corporation can obtain capital from outside investors under either of the following plans:

Plan 1 Group 1 will invest $100,000 to acquire 1,000 shares of $7.50, cumulative preferred shares and $72,000 to acquire 60,000 common shares. Each preferred share will receive 50 votes if preferred dividends are more than two years in arrears.

Plan 2 Group 2 will invest $150,000 to acquire 1,200 shares of $8.50 nonvoting, noncumulative preferred shares.

Required

Assume the corporation receives its articles of incorporation.

1. Journalize the issuance of common shares to Raylene Link and Samantha Chain.
2. Journalize the issuance of shares to the outsiders under both plans.
3. Assume that net income for the first year is $92,000, and total dividends of $17,400 are properly subtracted from retained earnings. Prepare the shareholders' equity section of the corporation balance sheet under both plans.
4. Recommend one of the plans to Chain and Link. Give your reasons.

Financial Statement Problem

Shareholders' equity (Obj. 2)

The Intrawest Corporation June 30, 2003, financial statements appear in Appendix A. Answer the following questions about the company's common shares.

1. Where can you find information about Intrawest's share capital? What classes of shares has Intrawest issued and are outstanding? How many shares are authorized and how many are issued?
2. Were any common shares issued during the year? If yes, at what price were the shares issued?
3. Intrawest has a plan whereby the company finances share purchases by employees. What is the name of the plan? How many common shares had the company issued under this plan at June 30, 2003?
4. What is the book value per share at June 30, 2003? The market price of the shares closed at $17.77 on that date. Why is the market price different from the book price?
5. What did Intrawest earn per common share in 2003? Where did you find that information?

CHAPTER

14

Retained Earnings, Share Repurchases, and the Income Statement

CHAPTER OBJECTIVES

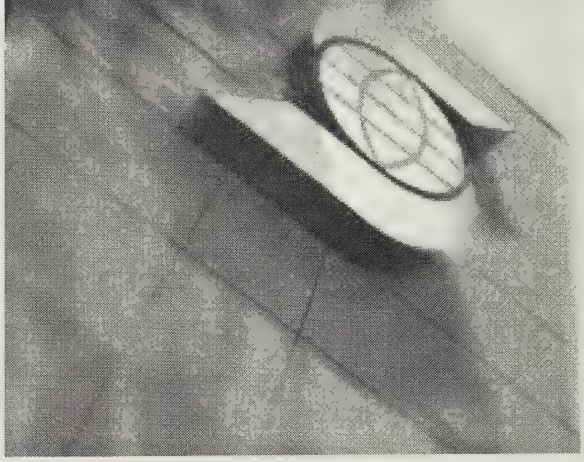
After studying this chapter, you should be able to

1. Account for stock dividends
2. Distinguish stock splits from stock dividends
3. Account for repurchased shares
4. Report restrictions on retained earnings
5. Analyze a complex income statement
6. Prepare a statement of retained earnings



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Visit the Media Companion CD-ROM that comes with this book for extra practice with the new material in Chapter 14.



A recent article in the *Financial Post* (January 6, 2004, p. FP2) stated that Scotiabank announced on January 5, 2004, that it planned to "purchase up to 25 million Bank of Nova Scotia common shares, approximately 5% of the 505,456,686 shares outstanding as of [December] 31, 2003." The *Financial Post* article also reported that Scotiabank had repurchased 4,688,200 of its common shares during 2003 at an average price of $55.60 per share. Other companies such as RBC Financial Group, QLT Inc. of Vancouver, CocaCola, and Dell Computer have either announced or made share repurchases recently.

These companies are all leaders in their respective industries. What do these five companies have in common? They have bought back or will buy back large amounts of their own shares. There are sound reasons for doing this, as we will see in this chapter.

Chapter 13 we saw how corporations raise capital by issuing their shares. Share issuance increases shareholders' equity. Companies also buy their own shares back from the shareholders. A share repurchase decreases both corporate assets and equity. The repurchased shares may be cancelled or reissued. In either event, the balance in the Common Shares account is reduced. Why do companies repurchase their own shares? This chapter covers the topic of share repurchases, along with retained earnings, stock dividends, and the corporate income statement. Let's begin with retained earnings.

Retained Earnings

KEY POINT

Retained Earnings is *not* a bank account. A $500,000 balance in Retained Earnings means that $500,000 of capital has been created by profits reinvested in the business.

We have seen that the owners' equity section of a corporation's balance sheet is called *shareholders' equity*. The contributed capital accounts and retained earnings make up the shareholders' equity section.

Retained Earnings carries the balance of the business's net income less all net losses from operations and less all dividends accumulated over the corporation's lifetime. *Retained* means "held onto" or "kept." Retained earnings is the shareholders' stake in total assets that come from profits. Successful companies grow by reinvesting the assets they generate from profitable operations. A debit balance in Retained Earnings is called a *deficit*. Retained earnings deficits are not common because they often indicate that the corporation may be facing corporate failure and bankruptcy.

A survey of 200 companies in 2001 indicates that 74 percent provide a separate statement of retained earnings, while 26 percent combine the statement of retained earnings with the income statement (Exhibit 14-1).[1]

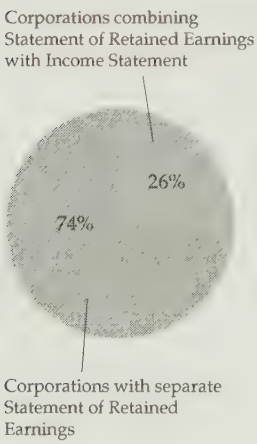
When you see a balance sheet, remember these facts about Retained Earnings:

1. *Credits to the Retained Earnings account arise only from net income.* Retained Earnings shows how much net income a corporation has earned and retained in the business. Its balance is the cumulative, lifetime earnings of the company less all net losses and all dividends.

2. *The Retained Earnings account is not a reservoir of cash.* Instead, Retained Earnings

EXHIBIT 14-1

Form of Statement of Retained Earnings



[1]Byrd, C., I. Chen and H. Chapman, *Financial Reporting in Canada* 2002, Twenty-seventh edition (Toronto: Canadian Institute of Chartered Accountants, 2002), p. 57.

represents no particular asset. In fact, the corporation may have a large balance in Retained Earnings but too little cash to pay a dividend.

- To *declare* a dividend, the company must have a credit balance in Retained Earnings, both before and after the declaration of dividends.
- To *pay* the dividend, it must have the cash.

Cash and Retained Earnings are two very different accounts—unrelated to each other.

Cash is an Asset. □ Retained Earnings is Shareholders' Equity.

LEARNING

Recall that, in a proprietorship, investments, net income, and withdrawals are all recorded in the Capital account. In a corporation, shareholders' equity is split into Contributed Capital and Retained Earnings. The Contributed Capital section holds capital invested. Retained Earnings is used to record net income, net loss, and dividends. The Retained Earnings amount is calculated as:

Beginning Retained Earnings
+Net Income
–Net Loss
–Dividends
=Ending Retained Earnings

Assume that the beginning balance of Retained Earnings was $70,000. The net loss for the year was $80,000. What will the Retained Earnings balance be after this net loss?

Answer:

Retained Earnings

Dec. 31, 2005	Net loss	80,000	Jan. 1, 2005	Bal.	70,000
Dec. 31, 2005	Bal.	10,000			

Stock Dividends

OBJECTIVE 1
Account for stock dividends

A **stock dividend** is a distribution by a corporation of its own shares to its shareholders. Stock dividends are fundamentally different from cash dividends because stock dividends do not give any assets to the shareholders. Stock dividends

- Affect *only* the accounts within shareholders' equity (including Retained Earnings and Common Shares)
- Have *no* effect on total shareholders' equity

A stock dividend increases Common Shares and decreases Retained Earnings. Both of these accounts are elements of shareholders' equity, so total shareholders' equity is unchanged. There is merely a transfer from Retained Earnings to Common Shares. No asset or liability is affected by a stock dividend, as shown in Exhibit 14-2.

The corporation distributes stock dividends to shareholders in proportion to the number of shares they already own. For example, suppose you owned 300 common shares of The Bank of Montreal. If The Bank of Montreal distributed a 10-percent common stock dividend, you would receive 30 (300 □ 0.10) additional shares. You would now own 330 common shares. All other Bank of Montreal shareholders would receive additional shares equal to 10 percent of their prior

EXHIBIT 14-2

Effects of a Stock Dividend

Common Shares ↑

Retained Earnings ↓

Total Shareholders' Equity is unchanged by a stock dividend.

holdings. You and all the other shareholders would be in the same relative ownership position after the dividend as you were before.

Reasons for Stock Dividends

Why do companies issue stock dividends? There are several reasons:

1. *To continue dividends but conserve cash.* A company may want to keep cash in the business, but also may wish to continue dividends in some form.
2. *To reduce the market price per share of its stock.* A stock dividend may cause the market price of a company's shares to fall because of the increased supply of the shares. Bombardier's Class B common shares traded at $6.85 per share recently. Doubling the number of its shares outstanding by issuing a stock dividend is likely to drop the market price of the shares by approximately half, to $3.42 per share. The objective of such a large stock dividend is to make the shares less expensive and thus more attractive to investors.

KEY POINT

A cash dividend involves the payment of a current asset (cash). A stock dividend is a distribution of a company's own shares, which are not an asset.

Recording Stock Dividends

The board of directors announces stock dividends on the declaration date. The date of record and the distribution date follow. (This is the same sequence of dates used for a cash dividend.) The declaration of a stock dividend does *not* create a liability because the corporation is not obligated to pay out assets. (Recall that a liability is a claim on *assets*.) Instead, the corporation has declared its intention to distribute its shares. Assume General Communications Corporation has the following shareholders' equity prior to a stock dividend:

KEY POINT

Never credit a *payable* account for a stock dividend. No liability is created when a stock dividend is declared, as compared to a cash dividend, which does create a liability.

Shareholders' Equity

Contributed capital	
Common shares, 100,000 shares authorized, 40,000 shares issued	$400,000
Retained earnings	100,000
Total shareholders' equity	$500,000

REAL WORLD EXAMPLE

When a shareholder receives a stock dividend, his percentage ownership in the company does not change. A stock dividend is taxable to the recipient. Dividend reinvestment plans (or DRIPs) result in taxable dividends, because a cash dividend is received and is used to buy additional shares immediately.

Of concern about stock dividends is how to determine the amount to transfer from retained earnings to the Common Shares account. The *Canada Business Corporations Act* suggests that the market value of the shares issued is the appropriate amount to transfer, while other incorporating acts allow the directors to set a value on the shares. If market value were to be used, it would be the market value on the date the dividend is declared. If any other value were to be used, it would be determined by the directors at the time of declaration. This issue is not dealt with in the *CICA Handbook*. The market value of the shares issued, on the declaration date, would seem to be an appropriate valuation in any event and will be used in this text.

Assume General Communications Corporation declares a 10 percent common stock dividend on November 17. The company will distribute 4,000 (40,000 □ 0.10) shares in the dividend. On November 17 the market value of its common shares is $16 per share. Using the market value approach, Retained Earnings is debited for the market value of the 4,000 dividend shares and Common Stock Dividend Distributable is credited. General Communications Corporation makes the following entry on the declaration date.

Nov.	17	Retained Earnings	64,000	
		Common Stock Dividend Distributable		64,000
		To declare a 10 percent common stock dividend. (40,000 × 0.10 × $16)		

The accounting equation for this transaction shows that a stock dividend does not affect assets, liabilities, or total shareholders' equity.

Assets	=	Liabilities	+	Shareholders' Equity
				−64,000
0	=	0		+64,000

On the distribution date, the company records issuance of the dividend shares as follows:

Dec.	12	Common Stock Dividend Distributable	64,000	
		Common Shares		64,000
		To issue common shares in a stock dividend.		

Common Stock Dividend Distributable is a shareholders' equity account. (It is *not* a liability because the corporation has no obligation to pay assets.) If the company prepares financial statements after the declaration of the stock dividend but before issuing it, Common Stock Dividend Distributable is reported in the shareholders' equity section of the balance sheet immediately after Common Shares. However, this account holds the value of the dividend shares only from the declaration date to the date of distribution.

The following tabulation shows the changes in shareholders' equity caused by the stock dividend:

Shareholders' Equity	Before the Dividend	After the Dividend	Change
Contributed capital			
Common shares, 100,000 shares authorized, 40,000 shares issued.....	$400,000		
44,000 shares issued.....		$464,000	**Up by $64,000**
Total contributed capital.....	400,000	464,000	**Up by $64,000**
Retained earnings.....	100,000	36,000	**Down by $64,000**
Total shareholders' equity.....	$500,000	$500,000	**Unchanged**

A stock dividend does not affect assets, liabilities, or total shareholders' equity. A stock dividend merely rearranges the shareholders' equity accounts, leaving total equity unchanged.

Stop & Think

Answer these questions to review stock and cash dividends:

1. How is a stock dividend like a cash dividend?
Answer: Both are a distribution to shareholders; both reduce Retained Earnings.

2. What happens to total share capital as a result of cash and stock dividends?
Answer: No change with a cash dividend; increase with a stock dividend (by the same amount that Retained Earnings decreases).

3. What happens to total shareholders' equity as a result of cash and stock dividends?
Answer: Decrease with cash dividend; no change with stock dividend.

4. Which type of dividend gives taxable income to the shareholder?
Answer: Both give taxable income to the shareholder; the stock dividend is valued at the market value of the shares on the date the stock dividend is declared.

Amount of Retained Earnings Transferred in a Stock Dividend Stock dividends are said to be *capitalized retained earnings* because they transfer an amount from retained earnings to contributed capital. The contributed capital accounts are more permanent than retained earnings because they cannot be paid out as dividends. Many shareholders view stock dividends as distributions little different from cash dividends.

Stock dividends, like cash dividends, are taxable in the hands of the recipient. The value of the stock dividend is equal to the amount of the increase in the capital of the company paying the dividend. The increase is usually the fair market value of the shares issued.

Stock Splits

A **stock split** is fundamentally different from a stock dividend. A stock split increases the number of authorized and outstanding shares with a proportionate reduction in the book value per share. For example, if the company splits its stock 2 for 1, the number of outstanding shares is doubled and each share's book value is halved. Many large companies in Canada—Dofasco, St. Lawrence Cement, The Bank of Nova Scotia, and others—have split their stock.

Assume that the market price of one common share of Arcadia Corp. is $100 and that the company wishes to decrease the market price to approximately $50. Arcadia decides to split the common shares 2 for 1 in the expectation that the share's market price would fall from $100 to $50. A 2-for-1 stock split means that the company would have two times as many shares outstanding after the split as it had before and that each share's book value would be halved. Assume Arcadia had 400,000 common shares issued and outstanding before the split.

Shareholders' Equity (before stock split; adapted)	($ millions)
Contributed capital	
Common shares, unlimited number of shares authorized, **400,000 shares issued**	$4.0
Retained earnings	1.8
Total shareholders' equity	$5.8

After the 2-for-1 split, Arcadia would have 800,000 common shares (400,000 × 2) outstanding. Total shareholders' equity would be exactly as before the stock split. Indeed, the balance in the Common Shares account does not even change. Only the number of shares issued and the book value per share change.

Because the stock split affects no account balances, no formal journal entry is necessary. Instead, the split is often recorded in a *memorandum entry* such as the following:

Aug. 19 Distributed one new common share for each old share previously outstanding. This increased the number of common shares issued from 400,000 to 800,000.

A company may engage in a reverse split (or consolidation) to decrease the number of shares outstanding. If the number of shares outstanding is decreased, then existing shareholders may have a better chance of maintaining control over a corporation's shares. There are fewer shares available to be traded and purchased by new shareholders. For example, Arcadia could split its stock 1 for 4, which would reduce the number of shares issued from 400,000 to 100,000. Reverse splits are rare.

Similarities and Differences between Stock Dividends and Stock Splits

OBJECTIVE 2
Distinguish stock splits from stock dividends

Stock dividends and stock splits both increase the number of shares owned per shareholder. Neither a stock dividend nor a stock split changes the investor's total cost of the shares owned. For example, assume you paid $32,000 to acquire 1,000 common shares of Western AquaCulture Ltd. If Western AquaCulture Ltd. distributes a 100 percent stock dividend, your 1,000 shares increase to 2,000, but your total cost is still $32,000. Likewise, if Western AquaCulture Ltd. distributes a 2-for-1 stock split, your shares increase in number to 2,000, but your total cost is unchanged.

Where stock dividends and stock splits differ, however, is in the way they are treated for tax purposes. A stock split does not create taxable income to the investor, but a stock dividend does because stock dividends are taxed in the same way as cash dividends. The stock dividend is valued at the market value of the shares on the date the stock dividend is declared, and this amount is included as taxable income. This is one reason why stock dividends are less popular than stock splits; investors must pay income tax on a stock dividend even though no cash is received.

Both a stock dividend and a stock split increase the corporation's number of shares issued. For example, a 100 percent stock dividend and a 2-for-1 stock split both double the outstanding shares and are likely to cut the stock's market price per share in half. They differ in that a stock *dividend* shifts an amount from retained earnings to contributed capital, leaving total book value unchanged. However, the book value per share will decrease because of the increased number of shares outstanding. A stock *split* affects no account balances whatsoever but instead changes the book value of each share.

Exhibit 14-3 summarizes the effects of dividends and stock splits on total shareholders' equity.

Income Trusts[2]

A new investment vehicle came into being in the mid-1990s. The vehicle is called an **income trust** or **investment trust**. It is quite simply a portfolio of assets that is designed ". . . to provide safety of principal and [a] regular fixed income... ."

An example of an income trust is Big Rock Brewery Income Trust of Calgary. In January 2003, Big Rock Brewery Ltd., which had shareholders but had not paid dividends on common shares, converted Big Rock shares into trust units.[3] The change provides individual unitholders (formerly shareholders) with the opportunity to receive monthly cash payments, but at the same time allows the unitholders to maintain their equity position in the company.

EXHIBIT 14-3

Effects of Dividends and Stock Splits on Total Shareholders' Equity

	Effect on Total Shareholders' Equity	
	Declaration	Payment of Cash or Distribution of Shares
Cash dividend	Decrease	None
Stock dividend	None	None
Stock split	None	None

Source: Adapted from Beverly Terry.

[2]Croft, Richard. "Income Trusts and How They Work," from the website www.moneysense.ca, accessed March 22, 2004.

[3]Big Rock Brewery Income Trust Annual Report, March 31, 2003.

OBJECTIVE 3
Account for repurchased shares

Repurchase of Its Shares by a Corporation

Corporations may **repurchase shares** from their shareholders for several reasons: (1) the company may have issued all its authorized shares and needs the shares for distributions to officers and employees under bonus plans or share purchase plans; (2) the purchase may help support the share's current market price by decreasing the supply of shares available to the public; and (3) management may gather in the shares to avoid a takeover by an outside party.

The *Canada Business Corporations Act* requires a corporation that purchases its own shares to cancel the shares bought; it may do so by treating the purchased shares as authorized but unissued, and issue them in the normal way at a later date, or it may cancel them outright. Several of the provincial incorporating acts also require that the shares be treated this way, while other incorporating acts permit the corporation to hold the shares as treasury shares (in effect, the corporation holds the shares in its treasury) and resell them.

Shares that are cancelled outright may not be reissued. The effect of purchasing an outstanding share is to reduce the number of shares issued; the effect of cancelling a share outright is to reduce the number of shares authorized.

For practical purposes, treasury shares are like unissued shares: neither category of shares is in the hands of shareholders. The company does not receive cash dividends on its treasury shares, and treasury shares do not entitle the company to vote or to receive assets in liquidation. The difference between unissued shares and treasury shares is that treasury shares have been issued and bought back.

The repurchase of its own shares by a company decreases the company's assets and its shareholders' equity. The size of the company literally decreases, as shown on the balance sheet. The *Canada Business Corporations Act* and most of the provincial incorporating acts do not permit a corporation to acquire its own shares if such reacquisition would result in the corporation's putting itself into financial jeopardy and being unable to pay its liabilities as they become due.

For companies incorporated under the *Canada Business Corporations Act* and in jurisdictions where repurchased shares must be cancelled or treated as unissued, the Common Shares account is debited. In those jurisdictions in Canada where treasury shares are permitted, the entry to record a purchase of treasury shares would include a debit to Treasury Shares and a credit to Cash. The Treasury Shares account has a debit balance, which is the opposite of the other shareholders' equity accounts. Therefore, Treasury Shares is a contra shareholders' equity account; it is deducted from the total of contributed capital and Retained Earnings to compute total shareholders' equity. Treasury shares are permitted in the U.S. but are rare in Canada. For this reason, the remainder of this text will *not* deal with treasury shares.

Repurchase of Shares

The *CICA Handbook* requires a company that purchases its own shares at a price less than the *average issue price* to debit Common Shares (or Preferred Shares, as the case may be) for the average issue price; the excess of the average issue price over the purchase price should be credited to Contributed Surplus—Share Repurchase. When a company purchases its own shares at a price equal to or greater than the average issue price, the excess should first be debited to Contributed Surplus—Share Repurchase to reduce the balance in this account to $0, and any remaining excess should then be debited to Retained Earnings. Under the *Canada Business Corporations Act*, any subsequent issues of repurchased shares are treated as new share issues, with the proceeds credited to the Common Shares account. The Contributed Surplus—Share Repurchase account is not adjusted.

Suppose Fundy Sea Products Inc. had the following shareholders' equity before repurchasing 10,000 of its own shares. Its 80,000 shares were issued at the same price, as follows:

Shareholders' Equity

Contributed capital	
Common shares, 100,000 shares authorized, 80,000 shares issued	$200,000
Retained earnings	150,000
Total shareholders' equity	$350,000

On November 22, 2005, Fundy Sea Products Inc. purchases 10,000 of its common shares, paying cash of $7.50 per share; the shares had been issued at $2.50 ($200,000 ÷ 80,000). The shares are to be cancelled. Fundy records the purchase as follows:

2005				
Nov.	22	Common Shares	25,000	
		Retained Earnings	50,000	
		Cash		75,000
		Purchased 10,000 shares at $7.50 per share.		

The shareholders' equity section of Fundy Sea Products Inc.'s balance sheet would appear as follows after the transaction:

Shareholders' Equity

Contributed capital	
Common shares, 90,000 shares authorized, 70,000 shares issued	$175,000
Retained earnings	100,000
Total shareholders' equity	$275,000

Observe that the purchase of the shares decreased the number of shares authorized and decreased the number of shares issued and outstanding. Only outstanding shares have a vote, receive cash dividends, and share in assets if the corporation liquidates. Notice that the dollar amount shown for Common Shares and Retained Earnings decreased by $25,000 and $50,000 respectively.

Assume the articles of incorporation for Dawson Resources Ltd., issued under the *Canada Business Corporations Act*, authorized it to issue 100,000 common shares. By February 28, 2006, Dawson Resources had issued 9,000 shares at a price of $20.00 per share. Common Shares on the balance sheet amounted to $180,000. Retained Earnings was $24,100.

On March 20, Dawson Resources repurchases 1,000 shares at $15.00 per share with the intention of reissuing the shares in the future. The company records the transaction as follows:

2006				
March	20	Common Shares	20,000	
		Contributed Surplus—Share Repurchase		5,000
		Cash		15,000
		Purchased 1,000 shares at $15 per share. Since the common shares repurchased had an issue value of $20,000 (1,000 × $20), the contributed surplus was $5,000 [1,000 × ($20 – $15)].		

The shareholders' equity section of Dawson Resources Ltd.'s balance sheet would appear as follows after the transaction:

WORKING IT OUT

Anderson Products Inc. issued 100,000 common shares at $10 per share. Later, when the market price was $15 per share, the company distributed a 10 percent stock dividend. Then Anderson Products Inc. repurchased 500 shares at $20 per share. What is the Common Shares balance?

A: $1,144,773:

100,000 shares × $10
= $1,000,000
+ 10% × 100,000 × $15
= 150,000
1,150,000
– 500 shares × 10.45*
= 5,227
$1,144,773

*$10.45 = $1,150,000 ÷ 110,000 shares

Shareholders' Equity

Contributed capital	
Common shares, 100,000 shares authorized, 8,000 shares issued	$160,000
Contributed surplus—Share Repurchase (note 6)	5,000
Total contributed capital	$165,000
Retained earnings	24,100
Total shareholders' equity	$189,100

Note 6: During the year, the company acquired 1,000 common shares at a price of $15.00 per share; the shares had been issued at $20.00 per share. The company intends to reissue these shares in the future.

Sale of Repurchased Capital Stock

A company incorporated under the *Canada Business Corporations Act* may reissue the shares that it previously had repurchased. The sale would be treated like a normal sale of authorized but unissued shares.

To continue our example, on June 18, 2006, Dawson Resources Ltd. sells 1,000 common shares for $22.00 per share. Exhibit 14-4 tracks the shareholders' equity of Dawson Resources Ltd. to show how these share repurchase and resale transactions affect corporate equity.

STOP & THINK

Share repurchase transactions have a serious ethical and legal dimension. A company buying its own shares must be extremely careful that its disclosures of information are complete and accurate. Otherwise, a shareholder who sold shares back to the company may claim that he or she was deceived into selling the shares at too low a price. What would happen if a company repurchased its own shares at $17 per share and one day later announced a technological breakthrough that would generate millions of dollars in new business?

Answer: The share price would likely increase in response to the new information. If it could be proved that management withheld the information, a shareholder selling shares back to the company may file a lawsuit to gain the difference per share. The shareholder would claim that, with the knowledge of the technological advance, he or she would have held the shares until after the price increase and been able to sell the shares at a higher price.

EXHIBIT 14-4

Shareholders' Equity of Dawson Resources Ltd.

Shareholders' equity before share repurchase transaction	Shareholders' equity after a $20,000 repurchase of shares.	Shareholders' equity after sale of the repurchased shares for $22,000.
	Equity decreases by $15,000.	Equity increases by $22,000.
$204,100 (Common Shares, $180,000)	$189,100 (Common Shares, $160,000)	$211,100 (Common Shares, $182,000)

No Gain or Loss from Repurchased Share Transactions

The repurchase and sale of its own shares do not affect a corporation's net income. Stock repurchase affects *balance sheet accounts*, not income statement accounts. Under the *Canada Business Corporations Act*, any sale of repurchased shares is treated like a new share issue, and no gain or loss is recognized. The fact that a company may have repurchased shares at a price different from their average issue price and then reissued shares later is not relevant. If the repurchased shares are cancelled outright, the number of shares authorized and issued is reduced. These shares, therefore, cannot be reissued. If the repurchased shares are not cancelled, the number of shares authorized remains the same but the number of shares issued is reduced. These shares may be reissued at some point in the future. At that point, the issue of shares is treated in the normal way, as a credit to Common Shares. The sale of 1,000 shares repurchased for $15,000 and resold for $22,000, discussed above, illustrates this point.

Accounting Around the Globe

Are Share Repurchases a Value Booster or a PR Gimmick?

What could signal more confidence than a company's repurchase of its own shares? Share repurchases were a strategy for investing spare cash in the 1990s. Now the repurchase has become a strategy for propping up a company's share prices. For example, the share price of Tenet Healthcare Corporation plunged by 50 percent in a week, and the healthcare giant paid $140 million to repurchase its own shares. The strategy worked, because two weeks later the share price had risen by 13 percent.

Repurchases of a company's own shares reduce the number of outstanding shares, and earnings per share go up. A dramatic example of this occurred when Deluxe, the U.S.'s leading cheque printer, repurchased 19 million of its own shares. Deluxe's share price has soared 116 percent since the repurchase.

When the market falls, boosting share price becomes a priority, and there's a rush of repurchase activity. In the second quarter of 2002, for instance, U.S. companies announced plans to repurchase $24 billion of their own shares. The key words here are "announced plans." Skeptical shareholders point out that share repurchase announcements aren't always followed by actual share repurchases. Columnist John Ellis says: "Nothing so perfectly captures the fibre of today's whimpering CEOs than the stock buyback (share repurchase) announcement." Ellis complains that CEOs don't always carry through on their repurchase announcements, "While many have been announced, probably 6 out of 10 [repurchases] are nothing more than public relations gimmicks."

Dividend announcements are different. Unlike a share repurchase announcement, a cash dividend, once declared, becomes a real liability. The joke among some financial analysts is this: "Share repurchases are like dating. A dividend is more like getting married."

Based on: Tom Petruno, "Stock Buybacks Face Increasing Scrutiny," *The Los Angeles Times*, November 24, 2002, p. C.13. Shaheen Pasha, "Stock Buybacks Have Increased as Equities Fall," *Wall Street Journal*, July 18, 2002, p. C9. John Ellis, "Strategy," *Fast Company*, October 2002, p. 74.

Review the first half of the chapter by studying the following Decision Guidelines feature.

Decision Guidelines — Accounting for Retained Earnings, Stock Dividends, Stock Splits, and Share Repurchases

Retained earnings, dividends, and share repurchase transactions are unique because they can affect a corporation's equity. These Decision Guidelines provide a foundation for both preparers and users of financial statements to understand their effects.

Decision	Guidelines
How would a corporation record:	
• Declaration of a stock dividend?	Retained Earnings ..... Market value Common Stock Dividend Distributable ..... Market value
• Stock split?	Memorandum only: Split the common stock 3 for 1. Distributed two new common shares for each one old share outstanding.

What are the effects of stock dividends and stock splits on each of the following?

	Effects of Stock Dividend	Effects of Stock Split (for example, a 2-for-1 split)
• Number of shares authorized	No effect	Increase
• Shares issued	Increase	Increase
• Shares outstanding	Increase	Increase
• Total assets and total liabilities	No effect	No effect
• Total shareholders' equity	No effect	No effect
• Common Shares account	Increase	No effect
• Retained Earnings account	Decrease	No effect

How would a corporation record repurchase of shares:

• At issue price?	Common Shares ..... Issue price Cash ..... Issue price
• Above issue price (with no relevant Contributed Surplus)?	Common Shares ..... Issue price Retained Earnings ..... Excess* Cash ..... Amount paid *Excess of amount paid over issue price
• Below issue price?	Common Shares ..... Issue price Contributed Surplus—Share Repurchase ..... Gain** Cash ..... Amount paid **Gain is equal to issue price minus amount paid.

What are the effects of the repurchase and subsequent sale of the repurchased shares on:

	Effects of Repurchase of Shares	Effects of Sale of Repurchased Shares
• Total assets?	Decrease by full amount of cash paid	Increase by full amount of cash received
• Total shareholders' equity?	Decrease by full amount of cash paid	Increase by full amount of cash received

OBJECTIVE 4
Report restrictions on retained earnings

Restrictions on Retained Earnings

Dividends and repurchases of shares require a cash payment. In fact, repurchases of shares are returns of their investment to the shareholders. These outlays decrease assets, so the corporation has fewer resources to pay liabilities. A bank may agree to lend $500,000 only if the borrowing corporation limits dividend payments and repurchases of its shares.

Limits on Dividends and Share Repurchases

To ensure that corporations maintain a minimum level of shareholders' equity for the protection of creditors, incorporating acts restrict the amount of its own shares that a corporation may repurchase. This restriction often focuses on the balance of retained earnings. Companies usually report their retained earnings restrictions in notes to the financial statements. The following disclosure in the 2002 financial statements by TransCanada PipeLines Limited (now TransCanada Corporation) is typical:

> **Note 12—Common Shares**
>
> **Restriction on Dividends** Certain terms of the Company's preferred shares, preferred securities, junior subordinated debentures, and debt instruments could restrict the Company's ability to declare dividends on preferred and common shares. At December 31, 2002, such terms did not restrict or alter the company's ability to declare dividends.

Stop & Think

Why would a borrower such as TransCanada PipeLines Limited agree to restrict dividends as a condition for receiving a loan?

Answer: To get a lower interest rate. Other things being equal, the greater the borrower's concessions, the more favourable the terms offered by the lender.

Appropriations of Retained Earnings

Appropriations are restrictions of Retained Earnings that are recorded by formal journal entries. A corporation may appropriate (segregate in a separate account) a portion of Retained Earnings for a specific use. For example, the board of directors may appropriate part of Retained Earnings for building a new manufacturing plant. A debit to Retained Earnings and a credit to a separate account—Retained Earnings Restricted for Plant Expansion—records the appropriation. Appropriated Retained Earnings is normally reported directly above the regular Retained Earnings account, with a footnote where the appropriation is more fully described.

Retained earnings appropriations are rare. Corporations generally disclose any retained earnings restrictions in the notes to the financial statements, as shown in "Note 12" above.

Variations in Reporting Shareholders' Equity

Accountants sometimes report shareholders' equity in ways that differ from our examples. We use a detailed format in this book to help you learn the components of shareholders' equity. Companies assume that investors and creditors understand the details.

One of the most important skills you will learn in this course is how to read the financial statements of actual companies. In Exhibit 14-5 we present a side-by-side comparison of our general teaching format and the format of The Bank of Nova Scotia taken from its 2003 annual report. Note the following points with respect to the real-world format illustrated in Exhibit 14-5 and also with regard to actual financial statements:

1. The Bank of Nova Scotia uses the heading Capital Stock. Companies may use Share Capital or other headings instead of Contributed Capital.

General Teaching Format		Real-World Format	
Shareholders' Equity ($ amounts in millions)		**Shareholders' Equity ($ amounts in millions)**	
Contributed capital		Capital stock (note 13)*	
Unlimited number of preferred shares authorized 22,242,900 issued	$ 800	Preferred shares	$ 800
		Common shares and contributed surplus	3,141
Unlimited number of common shares authorized 505,352,886 issued	3,140		
Contributed surplus re. stock options	1		
Retained earnings	11,747	Retained earnings	11,747
Cumulative foreign currency translation	(1,074)	Cumulative foreign currency translation	(1,074)
Total shareholders' equity	$14,614		$14,614

***Note 13: Capital Stock**

Authorized

An unlimited number of Preferred Shares without nominal or par value.

Unlimited number of Common Shares without nominal or par value.

**GAAP suggests the presentation of comparative data; in order to simplify the illustration, data are presented for 2003 only.

EXHIBIT 14-5

Formats for Reporting Shareholders' Equity**

2. Some companies combine all classes of contributed capital into a single line item and provide specifics in the notes. The Bank of Nova Scotia has combined two series of preferred shares in a single line item but does show preferred and common separately.
3. The preferred and common shares are described fully in the notes with respect to shares authorized and issued; the information in the balance sheet is limited to a description of the class and total amount for which each of the two classes of shares were issued.
4. Often total shareholders' equity is not specifically labelled.

Mid-Chapter Summary Problem for Your Review

Scopis Ltd. reported the shareholders' equity as shown on the next page.

1. What was the average issue price per common share?
2. Journalize the issuance of 1,200 common shares at $8.00 per share. Use Scopis Ltd.'s account titles.
3. How many Scopis Ltd. common shares are now outstanding?

4. How many common shares would be outstanding after Scopis Ltd. splits its common shares (computed in Requirement 3) 3 for 1?
5. Using Scopis Ltd. account titles, journalize the declaration of a 10 percent stock dividend when the market price of Scopis Ltd.'s common shares is $6.00 per share. Use the shares outstanding in Requirement 3.
6. Journalize the following share repurchase and sale transactions by Scopis Ltd., assuming they occur in the order given (Requirement 6 is independent of Requirement 5.)
   a. Scopis Ltd. purchases 500 shares at $16.00 per share.
   b. Scopis Ltd. purchases 500 shares at $4.00 per share.
   c. Scopis Ltd. sells 100 shares for $18.00 per share.
7. How many Scopis Ltd. common shares would be outstanding after the transactions in Requirement 6 take place? Ignore the transactions in Requirements 4 and 5.

Shareholders' Equity

Preferred shares, $1.00	
Authorized: 10,000 shares	
Issued: None	$ —
Common shares	
Authorized: 100,000 shares	
Issued: 14,000 shares	70,000
Retained earnings	84,000
	$154,000

Solution

1. Average issue price of the common shares was $5.00 per share ($70,000 ÷ 14,000 shares = $5.00).

2. Cash 9,600
   Common Shares 9,600
   To issue common shares for cash of $9,600 (1,200 × $8).

3. Shares outstanding = 15,200 (14,000 + 1,200).

4. Shares outstanding after a 3-for-1 stock split = 45,600 (15,200 shares outstanding × 3).

5. Retained Earnings 9,120
   Common Shares Dividend Distributable 9,120
   To declare a 10 percent common stock dividend valued at $9,120 (15,200 × 0.10 × $6).

6. a. Common Shares (500 × $5.24)* 2,620
      Retained Earnings [500 × ($16.00 – $5.24)*] 5,380
      Cash 8,000
      To purchase 500 shares at $16.00 per share.

   b. Common Shares (500 × $5.24)* 2,620
      Contributed Surplus—Share Repurchase [500 × ($5.24* – $4.00)] 620
      Cash 2,000
      To purchase 500 shares at $4.00 per share.

   c. Cash 1,800
      Common Shares 1,800
      To sell 100 shares at $18.00 per share.

7. Shares outstanding = 14,300 (15,200 – 500 – 500 + 100)

*[($70,000 + $9,600) ÷ 15,200] = $5.24

Cyber Coach

Visit the Study Guide on the Media Companion CD-ROM and the Student Resources area of the *Accounting* Companion Website for extra practice with the new material in Chapter 14.

www.pearsoned.ca/horngren

OBJECTIVE 5
Analyze a complex income statement

The Corporate Income Statement—Analyzing Earnings

KEY POINT

Businesses operate to generate profits; without profits a business will not exist for long. The main source of income for an ongoing business must be from regular, continuing operations, not from sources such as selling off a business segment.

Now that we have covered shareholders' equity in detail, we turn to the corporate income statement. Net income (revenues plus gains minus expenses and losses) receives more attention than any other item in the financial statements. In fact, net income is probably the most important piece of information about a company. Net income measures how successfully the company has operated. To shareholders, the larger the corporation's profit, the greater the likelihood of dividends. To creditors, the larger the corporation's profit, the better able it is to pay its debts. Net income builds up a company's assets and shareholders' equity. It also helps to attract capital from new investors who hope to receive dividends from future successful operations.

Suppose you are considering investing in the shares of Sobeys Inc. (www.sobeys.com), the grocery chain, Open Text Corporation (www.opentext.com), the info-tech company, or The Forzani Group Ltd. (www.forzanigroup.com), the sporting goods retailer. You would examine these companies' income statements. Of particular interest is the amount of net income they can expect to earn year after year. To understand net income, let's examine Exhibit 14-6 on the next page, which presents the income statement of Como Technology Inc., a small manufacturer of electronic switching equipment. (Refer to Chapter 5, page 238, for single-step and multi-step income statements.)

LEARNING

The first income tax expense listed on the income statement relates solely to income from continuing operations. Therefore, the tax effect of the discontinued segment's operating income (or loss) is not included in income tax expense; rather, it is added or deducted in the discontinued-operations part of the income statement.

Continuing Operations

Income from a business's continuing operations helps financial statement users make predictions about the business's future earnings. In the income statement of Exhibit 14-6, the topmost section reports income from continuing operations. This part of the business is expected to continue from period to period. In the absence of other information, we may use this information to predict that Como Technology Inc. will earn income of approximately $58,500 next year.

KEY POINT

Income before discontinued operations and extraordinary items (i.e., income from continuing operations) includes income from only those operations expected to remain in existence the following year. In Exhibit 14-6, if Como Technology Inc. had no discontinued operations and no extraordinary losses, then the $58,500 income from continuing operations would be the net income.

The continuing operations of Como Technology Inc. include three items deserving explanation. First, during 2006, the company had a $10,000 loss on restructuring operations. Restructuring costs include severance pay to laid-off workers, moving expenses for employees transferred to other locations, and environmental cleanup expenses. The restructuring loss is part of continuing operations because Como Technology Inc. is remaining in the same line of business. But the restructuring loss is highlighted as an "other" item (unusual item) on the income statement because its cause—restructuring—falls outside Como's main business endeavor, which is selling electronics products.

Second, Como Technology Inc. had a gain on the sale of machinery, which is also outside the company's core business activity. This explains why the gain is reported separately from Como's sales revenue, cost of goods sold, and gross margin. (For a review of sales, cost of goods sold, and gross margin, see Chapter 5.)

Third, income tax expense has been deducted in arriving at income before discontinued operations and extraordinary items (i.e., income from continuing operations). The tax corporations pay on their income is a significant expense. The combined federal and provincial income tax rates for corporations varies from

time to time, for type and size of company, and from province to province; the current rates range from 31 percent to a maximum rate of 39 percent. We will use an income tax rate of 35 percent in our illustrations. This is a reasonable estimate of combined federal and provincial income taxes. The $31,500 income tax expense in Exhibit 14-6 equals the pretax income from continuing operations multiplied by the tax rate ($90,000 × 0.35 = $31,500).

Discontinued Operations

Most large corporations engage in several lines of business. For example, The Jim Pattison Group (www.jimpattison.com) of Vancouver and ATCO Ltd. (www.atco.ca) of Calgary are very diversified conglomerates with several lines of business. Bombardier Inc. owns aerospace companies in Canada, the U.S., and Ireland for a world market, and manufactures subway cars for a world market. We call each significant part of a company a **segment of the business**.

A company may sell a segment of its business. Such a sale is not a regular source of income because a company cannot keep on selling its segments indefinitely. The sale of a business segment is viewed as a one-time transaction. Financial analysts typically do not include income or loss on discontinued operations to predict a company's future income. The discontinued segments will generate no income in the future.



REAL WORLD EXAMPLE

Segments represent major lines of business or geographic areas. TransCanada Pipelines Limited (now TransCanada Corporation) lists its segments as transmission, power, gas marketing, and corporate.

EXHIBIT 14-6

Corporation Income Statement

COMO TECHNOLOGY INC.
Income Statement
For the Year Ended December 31, 2006

Sales revenue		$500,000	Continuing operations
Cost of goods sold		240,000	
Gross margin		260,000	
Operating expenses (listed individually)		181,000	
Operating income		79,000	
Other gains (losses)			
Loss on restructuring operations	($10,000)		
Gain on sale of machinery	21,000	11,000	
Income from continuing operations before income tax		90,000	
Income tax expense		31,500	
Income before discontinued operations and extraordinary items		58,500	
Discontinued operations			Special items
Operating income, $30,000, less income tax of $10,500	$19,500		
Gain on disposal, $5,000, less income tax of $1,750	3,250	22,750	
Income before extraordinary items		81,250	
Extraordinary flood loss	(20,000)		
Less income tax saving	7,000	(13,000)	
Net income		$ 68,250	
Earnings per common share (30,000 shares outstanding)			Earnings per share
Income before discontinued operations and extraordinary items		$ 1.95	
Income from discontinued operations		0.76	
Income before extraordinary items		2.71	
Extraordinary loss		(0.43)	
Net income		$ 2.28	

The *CICA Handbook* requires that the income statement carry information on the segment that has been disposed of under the heading *Discontinued Operations*. This section of the income statement is divided into two components: (1) operating income (or loss) from the segment that is disposed of and (2) gain (or loss) on the disposal. Assume income and gains are taxed at the 35 percent rate. They would be reported as follows:

Discontinued operations	
Operating income, $30,000, less income tax, $10,500	$19,500
Gain on disposal, $5,000, less income tax, $1,750	3,250
	$22,750

This presentation appears in Exhibit 14-6.

It is necessary to separate discontinued operations into these two components because the company may operate the discontinued segment for part of the year. This is the operating income (or loss) component; it should include the results of operations of the segment from the beginning of the period to the disposal date. There is usually also a gain (or loss) on disposal. The transaction may not have been completed at the company's year end and so the gain (or loss) may have to be estimated. Following the conservatism concept, the estimated net loss should be recorded in the accounts at year end while an estimated net gain would not be recognized until it was realized.

It is important that the assets, liabilities, and operations of the segment can be clearly identified as separate from those of other operations of the company. The notes to the financial statements should disclose fully the nature of the discontinued operations and other relevant information about the discontinued operations, such as revenue to the date of discontinuance.

Discontinued operations are common in business. Recent examples include the sale by Molson Inc. (www.molson.com) of its 100 percent interest in the Molson Centre and its sale of the Montreal Canadiens Hockey Club.

Stop & Think

On September 1, 2005, Acme Equipment Corp. sells its division that manufactures mobile homes. The assets are sold at a gain of $1,700,000. The loss from operations for the year up to the date of sale was $960,000. The tax rate is 30 percent. How would you present the loss for the year and the sale of the division on the year ended December 31, 2005, income statement?

Answer: In the Discontinued Operations section, you would list two items:

Operating loss, $960,000, less income tax savings, $288,000	$ (672,000)
Gain on disposal, $1,700,000, less income tax, $510,000	$1,190,000

Extraordinary Gains and Losses (Extraordinary Items)

Extraordinary gains and losses, also called **extraordinary items**, must meet three criteria to be classed as extraordinary. The *CICA Handbook*, in Section 3480, requires extraordinary items to have these characteristics:

1. An item is extraordinary only if it is not expected to occur frequently. For example, a company that had property on a flood plain that was covered with water every four or five years could not treat losses from flood waters as extraordinary.
2. An item is extraordinary only if it is not typical of the normal business activities of the company. For example, inventory losses or gains, or losses from the sale of property would not be considered extraordinary, since a company that owned either one might normally expect to suffer a loss as a result of that ownership.

3. A gain or loss is extraordinary only if it does not depend on decisions or determinations made by management or owners. For example, the gain on the sale of property held for expansion would not be an extraordinary gain, whereas the gain on the expropriation of land by a municipality would normally be considered extraordinary because management cannot choose to refuse the transaction.

In short, to be classed as extraordinary, a transaction must be infrequent, unusual, and its result determined externally.

Extraordinary items are reported along with their income tax effect. Assume that Como Technology Inc. lost $20,000 of inventory in a flood in 2006. This loss, which reduces income, also reduces the company's income tax. The tax effect of the loss is computed by multiplying the amount of the loss by the tax rate. The tax effect decreases the net amount of the loss in the same way that the tax effect on income reduces the amount of net income. An extraordinary loss is reported along with its tax effect as follows:

Extraordinary flood loss	$(20,000)
Less income tax saving	7,000
	$(13,000)

Examine this item in the income statement in Exhibit 14-6. An extraordinary gain is reported the same way, net of the income tax on the gain.

Gains and losses from unusual or infrequent transactions that are not extraordinary, such as gains or losses from capital asset disposals or losses resulting from employee strikes, could be classified as *unusual* and would be separately disclosed on the income statement as part of income before discontinued operations and extraordinary items. An example is the gain on the sale of machinery in Exhibit 14-6. These items are *not* shown net of tax effects.

Stop & Think

How would you report on an income statement:
(1) $100,000 extraordinary gain, at a 35 percent tax rate, and
(2) $150,000 extraordinary loss, at a 35 percent tax rate?

Answer:

(1) Extraordinary gain	$100,000
Less income taxes	35,000
Extraordinary gain, net of tax	$ 65,000
(2) Extraordinary loss	$150,000
Less tax savings	52,500
Extraordinary loss, net of tax	$ 97,500

Earnings Per Share (EPS)

The final segment of a corporation income statement presents the company's earnings per share, abbreviated as EPS. In fact, GAAP requires that corporations disclose EPS figures on the income statement or in a note to the financial statements.

Earnings per share is the amount of a company's net income per outstanding common share. EPS is a key measure of a business's success. Consider Plaza Corporation with net income of $200,000, no preferred dividends, and 100,000 common shares outstanding. Its EPS is $2 ($200,000 ÷ 100,000). Quaid Corporation may also have net income of $200,000, and no preferred dividends but only 50,000 common shares outstanding. Its EPS is $4 ($200,000 ÷ 50,000).

$$\text{Earnings per share} = \frac{\text{Net income} - \text{preferred dividends}}{\text{Weighted average number of common shares outstanding}}$$

$$\text{EPS} = \frac{\$200{,}000}{100{,}000} = \$2$$

Plaza Corporation	
Net income:	$200,000
Common shares outstanding:	100,000

$$\text{EPS} = \frac{\$200{,}000}{50{,}000} = \$4$$

Quaid Corporation	
Net income:	$200,000
Common shares outstanding:	50,000

Just as the corporation lists separately its different sources of income from continuing operations, discontinued operations, and so on, the *CICA Handbook* requires it to list separately the EPS figure for income before discontinued operations and extraordinary items and net income for the period to emphasize the significance of discontinued operations and extraordinary items to a company's overall results.

Consider the income statement of Como Technology Inc. shown in Exhibit 14-6; in 2006, it had 30,000 common shares outstanding. Income before discontinued operations and extraordinary items was $58,500, income from discontinued operations net of tax was $22,750, and there was an extraordinary loss, net of tax saving, of $13,000. Adhering to the *CICA Handbook*, it presents the following disclosures:

Disclosure required	
Income per share before discontinued operations and extraordinary items ($58,500 ÷ 30,000)	$1.95
Net income per share [($58,500 + $22,750 – $13,000) ÷ 30,000]	2.28
Disclosure not required, but suggested for clarity	
Income per share from discontinued operations ($22,750 ÷ 30,000)	0.76
Loss per share from extraordinary items ($13,000 ÷ 30,000)	(0.43)

Note that the details of calculations shown above are for illustrative purposes only. They would not appear in formal financial statements.

Remember that the disclosure required by the *CICA Handbook* is a minimum. It is often in the user's interest to exceed that minimum as was done in Exhibit 14-6. The income statement user can better understand the sources of the business's EPS amounts when presented in this detail.

Weighted Average Number of Common Shares Outstanding Computing EPS is straightforward if the number of common shares outstanding does not change over the entire accounting period. For many corporations, however, this figure varies as the company issues new shares and repurchases its own shares over the course of the year. Consider a corporation that had 100,000 shares outstanding from January through November, then purchased 60,000 of its own shares for cancellation. This company's EPS would be misleadingly high if computed using 40,000 (100,000 – 60,000) shares. To make EPS as meaningful as possible, corporations use the weighted average number of common shares outstanding during the period.

Let's assume the following figures for IMC Communications Corporation. From January through May, 2005, the company had 240,000 common shares outstanding; from June through August, 200,000 shares; and from September through December, 210,000 shares. We compute the weighted average by considering the outstanding shares per month as a fraction of the year:

Number of Common Shares Outstanding		Fraction of Year		Weighted Average Number of Common Shares Outstanding
240,000	×	5/12	(January through May)	= 100,000
200,000	×	3/12	(June through August)	= 50,000
210,000	×	4/12	(September through December)	= 70,000
			Weighted average number of common shares outstanding during 2005	= 220,000

The 220,000 weighted average would be divided into net income to compute the corporation's EPS.

The calculation of weighted average number of common shares outstanding becomes complicated when there have been stock dividends or stock splits during the year. These issues are studied more fully in intermediate and advanced accounting courses.

Preferred Dividends Throughout the EPS discussion we have used only the number of common shares outstanding. Holders of preferred shares have no claim to the business's income beyond the stated preferred dividend. Even though preferred shares have no claims, preferred dividends do affect the EPS figure. Recall, the EPS is earnings per common share. Also recall that dividends on preferred shares are paid first. Therefore, preferred dividends must be subtracted from income subtotals (income before discontinued operations and extraordinary items and net income) in the computation of EPS.

If Como Technology Ltd. had 10,000 preferred shares outstanding, each with a $1.50 dividend, the annual preferred dividend would be $15,000 (10,000 □ $1.50). The $15,000 would be subtracted from the two income subtotals resulting in the following EPS computations:

Income before discontinued operations and extraordinary items [($58,500 – $15,000) ÷ 30,000]	$1.45
Net income [($68,250 – $15,000) ÷ 30,000]	1.78

The net income of Hart Corp. amounted to $3,750,000 for the year ended December 31, 2005. Hart Corp. had 200,000 $9.00 preferred shares and 310,000 common shares at the end of the year. At January 1, 2005, Hart Corp. had 270,000 shares outstanding and issued 40,000 shares on April 1. Calculate Hart Corp.'s EPS.

Answer:

Weighted average number of common shares:

$270{,}000 \times 3/12 = 67{,}500$

$310{,}000 \times 9/12 = 232{,}500$

$300{,}000$ shares

$$\text{EPS} = \frac{\$3{,}750{,}000 - (200{,}000 \times \$9)}{300{,}000 \text{ shares}}$$

$$= \frac{\$3{,}750{,}000 - \$1{,}800{,}000}{300{,}000}$$

$$= \$6.50$$

Dilution Some corporations make their bonds or preferred shares more attractive to investors by offering conversion privileges, which permit the holder to convert the bond or preferred shares into some specified number of common shares. Holders of convertible bonds or convertible preferred shares may exchange their securities for common shares. If in fact the bonds or preferred shares are converted into common shares, then the EPS will be diluted (reduced) because more common shares are divided into net income. Because convertible bonds or convertible preferred shares can be traded for common shares, the common shareholders want to know the amount of the decrease in EPS that would occur if conversion took place. To provide this information, corporations with convertible bonds or preferred shares outstanding present two sets of EPS amounts: EPS based on outstanding common shares (*basic EPS*), and EPS based on outstanding common shares plus the number of additional common shares that would arise from con-

version of the convertible bonds and convertible preferred shares into common (*fully diluted EPS*). The topic of dilution can be very complex and is covered more fully in intermediate accounting texts.

EPS is the most widely used accounting figure. Many income statement users place top priority on EPS. Also, a share's market price is related to a company's EPS. By dividing the market price of a company's share by its EPS, we compute a statistic called the *price-to-earnings* or *price-earnings ratio. The Globe and Mail Report on Business* reports the price-earnings ratios (listed as P/E) daily for hundreds of companies listed on the Toronto Stock Exchange (TSX), the Montréal Exchange, the TSX Venture Exchange, the New York Stock Exchange, and NASDAQ, as well as information on bonds, futures and options, and mutual funds.

Stop & Think

What makes earnings per share so useful as a business statistic?

Answer: Earnings per share is useful because it relates a company's income to one share of its stock. Share prices are quoted at an amount per share, and investors usually consider how much they must pay for a certain number of shares. Earnings per share is used to help determine the value of a share of stock.

OBJECTIVE 6
Prepare a statement of retained earnings

Statement of Retained Earnings

Retained earnings may be a significant portion of a corporation's shareholders' equity. The year's income increases the retained earnings balance, and dividends decrease it. Retained earnings is so important that some corporations prepare a financial statement outlining the major changes in this equity account, much as the statement of owner's equity presents information on changes in the equity of a proprietorship. The statement of retained earnings for Como Technology Inc. appears in Exhibit 14-7.

Some companies report income and retained earnings on a single statement. Exhibit 14-8 illustrates how Como Technology Inc. would combine its income statement and its statement of retained earnings.

Accounting for Errors and Changes in Accounting Policy

What happens when a company makes an error in recording revenues or expenses? Detecting the error in the period in which it occurs allows the company to make a correction before preparing that period's financial statements. But

EXHIBIT 14-7
Statement of Retained Earnings

COMO TECHNOLOGY INC.
Statement of Retained Earnings
For the Year Ended December 31, 2006

Retained earnings, January 1, 2006	$ 130,000
Net income for 2006	68,250
	198,250
Dividends for 2006	(21,000)
Retained earnings, December 31, 2006	$177,250

COMO TECHNOLOGY INC.
Statement of Income and Retained Earnings
For the Year Ended December 31, 2006

Income statement	Sales revenue	$500,000
	Cost of goods sold	240,000
	Gross margin	260,000
	Operating expenses (listed individually)	181,000
Statement of Retained Earnings	Net income for 2006	68,250
	Retained earnings, January 1, 2006	130,000
		198,250
	Dividends for 2006	(21,000)
	Retained earnings, December 31, 2006	$177,250
	Earnings per common share (30,000 shares outstanding)	
	Income before discontinued operations and extraordinary items	$1.95
	Income from discontinued operations	0.76
	Income before extraordinary items	2.71
	Extraordinary loss	(0.43)
	Net income	$2.28

EXHIBIT 14-8

Statement of Income and Retained Earnings

failure to detect the error until a later period means that the business will have reported an incorrect amount of income on its income statement. After closing the revenue and expense accounts, the Retained Earnings account will absorb the effect of the error, and its balance will be wrong until the error is corrected.

Corrections to the beginning balance of Retained Earnings for errors of an earlier period or to reflect retroactive application of a change in accounting policy are called **prior-period adjustments**. To correct an error, the correcting entry includes a debit or credit to Retained Earnings for the error amount and a debit or credit to the asset or liability account that was misstated. The prior-period adjustment appears on the corporation's statement of retained earnings to indicate to readers the amount and the nature of the change in the Retained Earnings balance.

Assume that Paquette Corporation recorded the closing inventory balance for 2005 as $30,000. The correct amount was $40,000. This error resulted in overstating 2005 expenses by $10,000 and understating net income by $10,000. A review of the inventory working papers after the financial statements were issued alerted the Paquette Corporation management to the mistake. The entry to record this prior-period adjustment in 2006* is

2006				
June 19	Inventory		10,000	
	Retained Earnings			10,000
	Prior-period adjustment to correct error in recording closing inventory in 2005.			

The credit to Retained Earnings adjusts retained earnings to reflect the understated income in 2005. If cost of goods sold is credited in 2006 when the prior-period adjustment is recorded, income in 2006 would be overstated. The journal entry properly locates the adjustment in the period prior to 2006 (ie., to 2005, when the error occurred.)

*We disregard the income tax effects to simplify the illustration.

This prior-period adjustment would appear on the statement of retained earnings, as follows:

PAQUETTE CORPORATION
Statement of Retained Earnings
For the Year Ended December 31, 2006

Retained earnings, January 1, 2006 as originally reported	$390,000
Adjustment to correct error in recording closing inventory in 2005 (see Note XX)	10,000
Retained earnings, January 1, 2006, as adjusted	400,000
Net income for 2006	114,000
	514,000
Dividends for 2006	(41,000)
Retained earnings balance, December 31, 2006	$473,000

Our example shows a prior-period adjustment for additional revenue. To make a prior-period adjustment for additional expense, retained earnings is debited and the misstated asset or liability is credited.

The *CICA Handbook* suggests that, where appropriate, a change in accounting policy should be applied retroactively and confirms that prior periods should be restated to reflect the change and the facts of the restatement should be disclosed in the notes. An example would be a change in amortization method. The effect of the change on prior periods' results would appear as a prior-period adjustment on the Statement of Retained Earnings, the same way as an error would.

The Decision Guidelines feature covers the major aspects of a corporate income statement.

Analyzing a Corporate Income Statement

You graduated from college three years ago and you have saved $5,000 during that time. You are ready to start investing. Where do you start? You might begin by analyzing the income statements of Sobeys Inc., Open Text Corporation, and The Forzani Group Ltd. These Decision Guidelines will help you understand a corporate income statement.

Decision	Guidelines
What are the main sections of the income statement?	**Continuing operations** • Continuing operations, including unusual (but not extraordinary) gains and losses and income tax expense **Special items** • Discontinued operations—gain or loss—less the income tax effect • Extraordinary gain or loss, less the income tax effect • Net income (or net loss) **Earnings per share** • Earnings per share—applies only to net income (or net loss) and its components
What earnings per share (EPS) figures must a corporation report?	Must compute separate EPS figures for all amounts that apply, including • Income before discontinued operations and extraordinary items • Discontinued operations (recommended) • Income before extraordinary items (recommended)

(Continued)

- Extraordinary gain or loss
- Net income (or net loss)
- Basic EPS must be presented; fully diluted EPS should be presented by corporations that have bonds or preferred shares with conversion privileges.

How is basic EPS for net income computed?

$$\text{EPS} = \frac{\text{Net income} - \text{Preferred dividends}}{\text{Weighted-average number of common shares outstanding}}$$

Summary Problem for Your Review

The following information was taken from the ledger of Caravale Inc. at December 31, 2005:

Loss on sale of discontinued operations	$40,000	Selling expenses	$156,000
Prior-period adjustment—credit to Retained Earnings	10,000	Common shares, 40,000 shares issued	310,000
Gain on sale of capital assets	42,000	Sales revenue	1,240,000
Cost of goods sold	760,000	Interest expense	60,000
Income tax expense (saving)		Extraordinary gain	80,000
Continuing operations	56,000	Operating income, discontinued operations	60,000
Discontinued operations		Loss due to lawsuit	22,000
Operating income	21,000	General expenses	124,000
Loss on sale	(14,000)	Preferred shares, $8.00, 1,000 shares issued	100,000
Extraordinary gain	28,000	Retained earnings, January 1, 2005, as originally reported	206,000
Total dividends	32,000		

Required

Prepare a single-step income statement (presented on page 778) first and then a statement of retained earnings for Caravale Inc. for the year ended December 31, 2005. Include the earnings per share presentation and show computations. Assume no changes in the share accounts during the year.

Solution

CARAVALE INC.
Statement of Retained Earnings
For the Year Ended December 31, 2005

Retained earnings, January 1, 2005, as originally reported	$206,000
Prior-period adjustment—credit (Note X)	10,000
Retained earnings, January 1, 2005, as adjusted	216,000
Net income for current year	169,000
	385,000
Dividends for 2005	(32,000)
Retained earnings, December 31, 2005	$353,000

CARAVALE INC.
Income Statement
For the Year Ended December 31, 2005

Revenue and gains			
Sales revenue			$1,240,000
Gain on sale of capital assets			42,000
Total revenues and gains			1,282,000
Expenses and losses			
Cost of goods sold		$760,000	
Selling expenses		156,000	
General expenses		124,000	
Interest expense		60,000	
Loss due to lawsuit		22,000	
Income tax expense		56,000	
Total expenses and losses			1,178,000
Income before discontinued operations and extraordinary items			104,000
Discontinued operations (Note A)			
Operating income	$60,000		
Less income tax*	21,000	39,000	
Loss on sale of discontinued operations	(40,000)		
Less income tax saving*	14,000	(26,000)	13,000
Income before extraordinary items			117,000
Extraordinary gain (Note B)		80,000	
Less income tax*		28,000	52,000
Net income			$ 169,000

Earnings per share	
Income before discontinued operations and extraordinary item [($104,000 – $8,000) ÷ 40,000 shares]	$2.40**
Income from discontinued operations ($13,000 ÷ 40,000 shares)	0.33
Income before extraordinary items [($117,000 – $8,000) ÷ 40,000 shares]	2.73
Extraordinary gain ($52,000 ÷ 40,000 shares)	1.30
Net income [($169,000 – $8,000) ÷ 40,000 shares]	$4.03**

Computations:

$$\text{EPS} = \frac{\text{Income} - \text{Preferred dividends}}{\text{Weighted average number of common shares outstanding}}$$

Preferred dividends: 1,000 × $8.00 = $8,000

* The income tax rate is 35 percent.

** These calculations are required; the other EPS calculations are included to make the statements more informative for users.

Cyber Coach

Visit the Study Guide on the Media Companion CD-ROM and the Student Resources area of the *Accounting* Companion Website for extra practice with the new material in Chapter 14.

www.pearsoned.ca/horngren

Summary

1. **Account for stock dividends.** *Retained Earnings* carries the balance of the business's net income accumulated over its lifetime, less all declared dividends and net losses. *Cash dividends* are distributions of corporate assets made possible by earnings. *Stock dividends* are distributions of the corporation's own shares to its shareholders.
2. **Distinguish stock splits from stock dividends.** Stock dividends shift amounts from retained earnings to contributed capital. *Stock splits* do not change any account balances. Stock splits and stock dividends increase the number of shares outstanding and thus lower the market price per share.
3. **Account for repurchased shares.** *Repurchased shares* are the corporation's own shares that have been issued and reacquired. The corporation may issue repurchased shares in the normal way or may cancel the repurchased shares.
4. **Report restrictions on retained earnings.** Retained earnings may be *restricted* by law or contract or by the corporation itself. An *appropriation* is a restriction of retained earnings that is recorded by formal journal entries and appears on the balance sheet as a separate Retained Earnings item.
5. **Analyze a complex income statement.** The corporate *income statement* lists separately the various sources of income—*income before discontinued operations and extraordinary items* (which includes unusual gains and losses), *discontinued operations*, and *extraordinary gains and losses*. The bottom line of the income statement reports *net income* or *net loss* for the period. *Income tax expense* and *earnings-per-share* figures also appear on the income statement, likewise divided into different categories based on the nature of income.
6. **Prepare a statement of retained earnings.** A statement of retained earnings reports the changes in the Retained Earnings account, including prior-period adjustments, net income or net loss, and dividends paid. This statement may be combined with the income statement.

Self-Study Questions

Test your understanding of the chapter by marking the best answer for each of the following questions:

1. A corporation has total shareholders' equity of $200,000, including retained earnings of $38,000. The cash balance is $70,000. The maximum cash dividend the company can declare and pay is *(pp. 754–755)*
   a. $38,000 c. $130,000
   b. $70,000 d. $200,000
2. A stock dividend *(p. 755)*
   a. Decreases shareholders' equity
   b. Decreases assets
   c. Leaves total shareholders' equity unchanged
   d. None of the above
3. Meyer's Thrifty Acres Ltd. has 10,000 common shares outstanding; the shares were issued at $20.00 per share. The share's market value is $40.00 per share. Meyer's board of directors declares and distributes a common stock dividend of one share for every ten held. Which of the following entries shows the full effect of declaring and distributing the dividend? *(pp. 755–756)*

a. Retained Earnings	40,000	
Common Stock Dividend Distributable		40,000
b. Retained Earnings	20,000	
Common Shares		20,000
c. Retained Earnings	20,000	
Cash		20,000
d. Retained Earnings	40,000	
Common Shares		40,000

4. Lang Real Estate Investment Corporation declared and distributed a 50 percent stock dividend. Which of the following stock splits would have the same effect on the number of Lang shares outstanding? *(p. 759)*
   a. 2 for 1 c. 4 for 3
   b. 3 for 2 d. 5 for 4
5. Deer Lake Outfitters Ltd. purchased 10,000 of its common shares that had been issued at $1.50 per share, paying $6.00 per share. This transaction *(p. 760)*
   a. Has no effect on company assets
   b. Has no effect on shareholders' equity
   c. Decreases shareholders' equity by $15,000
   d. Decreases shareholders' equity by $60,000

6. A restriction of retained earnings *(pp. 764–765)*
   a. Has no effect on total retained earnings
   b. Reduces retained earnings available for the declaration of dividends
   c. Is usually reported by a note
   d. All of the above
7. Which of the following items is not reported on the income statement? *(p. 769)*
   a. Issue price of shares
   b. Extraordinary gains and losses
   c. Income tax expense
   d. Earnings per share
8. The income statement item that is likely to be most useful for predicting income from year to year is *(pp. 768–771)*
   a. Extraordinary items
   b. Discontinued operations
   c. Income before discontinued operations and extraordinary items
   d. Net income
9. In computing earnings per share (EPS), dividends on preferred shares are *(pp. 771–774)*
   a. Added because they represent earnings to the preferred shareholders
   b. Subtracted because they represent earnings to the preferred shareholders
   c. Ignored because they do not pertain to the common shares
   d. Reported separately on the income statement
10. A corporation accidentally overlooked an accrual of property tax expense at December 31, 2005. Accountants for the company detect the error early in 2006 before the expense is paid. The entry to record this prior-period adjustment for a prior year's error is *(pp. 774–776)*

a. Retained Earnings	XXX	
Property Tax Expense		XXX
b. Property Tax Expense	XXX	
Property Tax Payable		XXX
c. Retained Earnings	XXX	
Property Tax Payable		XXX
d. Property Tax Payable	XXX	
Property Tax Expense		XXX

Answers to the Self-Study Questions follow the Similar Accounting Terms.

Accounting Vocabulary

Appropriation of retained earnings *(p. 765)*
Earnings per share (EPS) *(p. 771)*
Extraordinary gain or loss *(p. 770)*
Extraordinary item *(p. 770)*
Income trust *(p. 759)*
Investment trust *(p. 759)*
Prior-period adjustment *(p. 775)*
Repurchase of own shares *(p. 760)*
Segment of a business *(p. 769)*
Stock dividend *(p. 755)*
Stock split *(p. 758)*

Similar Accounting Terms

Contributed capital	Share capital; Capital stock
Extraordinary gains and losses	Extraordinary items
Income Statement	Statement of Earnings
Income Trust	Investment Trust
Price-to-earnings ratio	Price-earnings ratio; P/E ratio
Shareholders' equity	Stockholders' equity

Answers to Self-Study Questions

1. a
2. c
3. d
4. b
5. d
6. d
7. a
8. c
9. b
10. c

Assignment Material

Questions

1. Identify the two main parts of shareholders' equity and explain how they differ.
2. Identify the account debited and the account credited from the last closing entry a corporation makes each year. What is the purpose of this entry?
3. Tam Logistics Ltd. reported a cash balance of $3 million and a retained earnings balance of $18 million. Explain how Tam Logistics Ltd. can have so much more retained earnings than cash. In your answer, identify the nature of retained earnings and state how it ties to cash.
4. Give two reasons for a corporation to distribute a stock dividend.
5. A friend of yours receives a stock dividend on an investment. She believes stock dividends are the same as cash dividends. Explain why the two are not the same.
6. Csordas Properties Inc. declares a stock dividend on June 21 and reports Stock Dividend Payable as a liability on the June 30 balance sheet. Is this correct? Give your reason.
7. What value is normally assigned to shares issued as a stock dividend?
8. Explain the similarity and difference between a 100 percent stock dividend and a 2-for-1 stock split to the corporation issuing the stock dividend and the stock split.
9. Give three reasons why a corporation may repurchase its own shares.
10. What effect does the repurchase of shares have on the (a) assets and (b) issued and outstanding shares of the corporation?
11. What effect does the repurchase and cancellation of common shares have on the (a) assets, (b) authorized shares, and (c) issued and outstanding shares of the corporation?
12. What does the *Canada Business Corporations Act* (CBCA) require a company to do when it repurchases its own shares?
13. Are there any exceptions to the requirement of the CBCA mentioned in question 12? If so, what are they?
14. Incorporating legislation frequently has a prohibition on a corporation's purchasing its own shares in certain circumstances. What are those circumstances? Why does the prohibition exist?
15. Why do creditors wish to restrict a corporation's payment of cash dividends and repurchases of the corporation's shares?
16. What are two ways to report a retained earnings restriction? Which way is more common?
17. Identify three items on the income statement that generate income tax expense. What is an income tax saving, and how does it arise?
18. Why is it important for a corporation to report income before discontinued operations and extraordinary items (income from continuing operations) separately from discontinued operations and extraordinary items?
19. Give two examples of extraordinary gains and losses and four examples of gains and losses that are *not* extraordinary.
20. What is the most widely used of all accounting statistics? What is the price-earnings ratio? Compute the price-earnings ratio for a company with EPS of $2.25 and a market price of $18.00 per common share.
21. What is the earnings per share of Singh Realty Ltd., which had net income of $63,000 and a weighted average number of common shares of 18,000?
22. What account do all prior-period adjustments affect? On what financial statement are prior-period adjustments reported?

Exercises

Exercise 14-1 *Journalizing a stock dividend and reporting shareholders' equity* **(Obj. 1)**

The shareholders' equity for Gazzola Bros. Paving Inc. on June 30, 2005 (end of the company's fiscal year), follows:

Shareholders' Equity	
Common shares, 800,000 shares authorized, 50,000 shares issued	$ 500,000
Retained earnings	635,000
Total shareholders' equity	$1,135,000

On August 8, 2005, the market price of Gazzola Bros. Paving Inc.'s common shares was $12.00 per share and the company declared a 20 percent stock dividend. Gazzola Bros. Paving Inc. issued the dividend shares on August 31, 2005.

Required

1. Journalize the declaration and distribution of the stock dividend.
2. Prepare the shareholders' equity section of the balance sheet after the stock dividend distribution.

Exercise 14-2 *Journalizing dividends and reporting shareholders' equity* **(Obj. 1)**

Adanac Travel Ltd. is authorized to issue 500,000 common shares. The company issued 70,000 shares at $10.00 per share. On June 10, 2005, when the retained earnings balance was $482,000, Adanac Travel Ltd. declared and distributed a 40 percent stock dividend, using the market value of $4.00 per share. On August 5, 2005, Adanac Travel Ltd. declared and paid a $0.60 per share cash dividend.

Required

1. Journalize the declaration and distribution of the stock dividend.
2. Journalize the declaration and payment of the cash dividend.
3. Prepare the shareholders' equity section of the balance sheet after both dividends.

Exercise 14-3 *Reporting shareholders' equity after a stock split* **(Obj. 2)**

Brandon Metal Products Ltd. had the following shareholders' equity at October 31, 2005:

Common shares, 300,000 shares authorized, 40,000 shares issued	$200,000
Retained earnings	487,000
Total shareholders' equity	$687,000

On November 14, 2005, Brandon Metal Products Ltd. split its common shares 3 for 1. Make the memorandum entry to record the stock split, and prepare the shareholders' equity section of the balance sheet immediately after the split.

Exercise 14-4 *Accounting for a reverse stock split* **(Obj. 2)**

Examine Brandon Metal Products Ltd.'s shareholders' equity section for October 31, 2005, in Exercise 14-3. Suppose Brandon Metal Products Ltd. consolidated its common shares 1 for 2 (a reverse stock split) in order to increase the market price of its shares. The company's shares were trading at $12 immediately before the split. Make the memorandum entry to record the share consolidation, and prepare the shareholders' equity section of Brandon Metal Products Ltd.'s balance sheet after

the share consolidation. What would you expect the market price to be, approximately, after the reverse split?

Exercise 14-5 *Using a stock split or a stock dividend to decrease the market price of a share* ***(Obj. 2)***

ConnectCom Corp., an internet service provider, has prospered during the past seven years, and recently the company's share price has shot up to $92. ConnectCom's management wishes to decrease share price to the range of $44 to $48, which will be attractive to more investors. Should the company issue a 100 percent stock dividend or split the stock? Why? If you propose a stock split, state the split ratio that will accomplish the company's objective. Show your computations.

Exercise 14-6 *Effects of share issuance, dividends, and share repurchase transactions* ***(Obj. 1, 2, 3)***

Identify the effects of these transactions on shareholders' equity. Has shareholders' equity increased, decreased, or remained the same? Each transaction is independent.

a. Issuance of 10,000 common shares at $14.50.
b. A 20 percent stock dividend. Before the dividend, 250,000 common shares were outstanding; market value was $13.25 at the time of the dividend.
c. Sale of 1,000 repurchased common shares for $12.75 per share. Cost of the shares was $8.25 per share.
d. A four-for-one stock split. Prior to the split, 60,000 common shares were outstanding.
e. Purchase of 3,000 common shares at $8.25 per share.

Exercise 14-7 *Journalizing share repurchase transactions* ***(Obj. 3)***

Journalize the following transactions that AVA Technologies Ltd. conducted during 2006:

Feb. 19	Issued 8,000 common shares at $26 per share.
Apr. 24	Purchased 2,000 common shares at $20 per share.
Nov. 12	Sold 400 repurchased shares at $23 per share.
Dec. 6	Sold 300 repurchased shares at $16 per share.

Exercise 14-8 *Journalizing repurchase of company shares and reporting shareholders' equity* ***(Obj. 3)***

Jacini Ltd. had the following shareholders' equity on March 26, 2005:

Shareholders' Equity

Common shares, 600,000 shares authorized, 120,000 shares issued	$ 720,000
Retained earnings	904,000
Total shareholders' equity	$1,624,000

On May 3, 2005, the company repurchased and retired 5,000 common shares at $7.00 per share. Journalize this transaction and prepare the shareholders' equity section of the balance sheet at June 30, 2005.

Exercise 14-9 *Accounting for the retirement of preferred shares* **(Obj. 3)**

Study Exhibit 14-5 on page 766. Suppose The Bank of Nova Scotia retired its preferred shares. What would be the amount of the company's total shareholders' equity if the cost to retire the preferred shares was (a) $750 million, (b) $800 million, (c) $850 million?

Exercise 14-10 *Reporting a retained earnings restriction* **(Obj. 4)**

The agreement under which Kirchler Transport Ltd. issued its long-term debt requires the restriction of $300,000 of the company's retained earnings balance. Total retained earnings is $642,000, and total contributed capital is $400,000.

Required

Show how to report shareholders' equity (including retained earnings) on Kirchler Transport Ltd.'s balance sheet at December 31, 2006, assuming:

a. Kirchler Transport Ltd. discloses the restriction in a note. Write the note.

b. Kirchler Transport Ltd. appropriates retained earnings in the amount of the restriction and includes no note in its statements.

c. Kirchler Transport Ltd.'s cash balance is $180,000. What is the maximum amount of cash dividends Kirchler Transport Ltd. can declare?


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Exercise 14-11 *Preparing a multiple-step income statement* **(Obj. 5)**

The ledger of Dao Plastics Inc. contains the following information for operations for the year ended September 30, 2005:

Sales revenue	$640,000	Income tax saving—extraordinary loss	$14,000
Operating expenses (not including income tax)	140,000	Income tax expense—gain on discontinued operations	7,000
Cost of goods sold	420,000	Extraordinary loss	40,000
Gain on discontinued operations	20,000	Income tax expense	28,000

Required

Prepare a multiple-step income statement for the year ended September 30, 2005. Omit earnings per share. Was 2005 a good year or a bad year for Dao Plastics Inc.? Explain your answer in terms of the outlook for 2006.

Exercise 14-12 *Computing earnings per share* **(Obj. 5)**

Scotia Solutions Inc. earned net income of $140,000 in 2005. The ledger reveals the following figures:

Preferred shares, $3.00, 4,000 shares issued and outstanding	$ 16,000
Common shares, unlimited shares authorized, 100,000 shares issued	600,000

Required

Compute Scotia Solutions Inc.'s EPS for 2005, assuming no changes in the share accounts during the year.

Exercise 14-13 *Computing earnings per share* **(Obj. 5)**

Osmonov Construction Ltd. had 60,000 common shares and 20,000 $1.50 preferred shares outstanding on June 30, 2005. On November 30, 2005, the company issued 6,000 additional common shares. There were no other share issuances and no share repurchases during the year ended June 30, 2006. Income for the year before

discontinued operations and extraordinary items was $137,800, and loss on discontinued operations (net of income tax) was $8,200. The company had an extraordinary loss (net of income tax) of $18,000.

Required

Compute Osmonov Construction Ltd.'s EPS amounts for the year ended June 30, 2006, starting with income before discontinued operations and extraordinary items.

Exercise 14-14 *Preparing a statement of retained earnings* ***(Obj. 5, 6)***



Best Pacific Hotels Inc., a large hotel chain, had retained earnings of $425 million at the beginning of 2005. The company showed these figures at December 31, 2005:

	($ millions)
Net income	$138
Cash dividends—preferred	3
common	89
Debit to retained earnings due to repurchase of preferred shares	8

Required

Prepare the statement of retained earnings for Best Pacific Hotels Inc. for the year ended December 31, 2005.

Exercise 14-15 *Preparing a statement of retained earnings with a prior-period adjustment* ***(Obj. 6)***



Halifax Concrete Products Ltd. reported a prior-period adjustment for the year ended October 31, 2006. An inventory error caused net income of prior years to be overstated by $180,000. Retained earnings at November 1, 2005, as previously reported, stood at $4,816,000. Net income for the year ended October 31, 2006, was $896,000, and dividends were $122,000.

Required

Prepare the company's statement of retained earnings for the year ended October 31, 2006.

Exercise 14-16 *Preparing a statement of retained earnings* ***(Obj. 6)***

For the year ended December 31, 2005, Glen Owen Inc. reported the following shareholders' equity:

Common shares, 400,000 shares authorized, 90,000 shares issued	$1,800,000
Retained earnings	864,000
	$2,664,000

During 2006, Glen Owen Inc. completed these transactions and events (listed in chronological order):

a. Declared and issued a 20 percent stock dividend. At the time, Glen Owen Inc.'s common shares were quoted at a market price of $21 per share.
b. Sold 1,000 common shares for $24 per share.
c. Sold 500 common shares to employees at $16 per share.
d. Net income for the year was $382,000.
e. Declared and paid cash dividends of $180,000.

Required

Prepare Glen Owen Inc.'s statement of retained earnings for 2006.

Challenge Exercise

Exercise 14-17 *Recording a stock dividend and preparing a statement of retained earnings* ***(Obj. 1, 6)***

Terra Environmental Products Inc. (TEPI) began 2005 with 1.6 million common shares issued and outstanding for $8 million. Beginning retained earnings was $7 million. On February 26, 2005, TEPI issued 100,000 common shares at $8 per share. On November 16, 2005, when the market price was $10 per share, the board of directors declared and distributed a 20 percent stock dividend. Net income for the year was $1.1 million.

Required

1. Make the journal entries for the issuance of shares for cash and for the 20 percent stock dividend.
2. Prepare the company's statement of retained earnings for the year ended December 31, 2005.

Beyond the Numbers

Beyond the Numbers 14-1 *Reporting special items* ***(Obj. 3, 5)***

The following accounting issues have arisen at Target Computers Corp.:

1. An investor noted that the market price of shares seemed to decline after the date of record for a cash dividend. Why do you think that would be the case?
2. Corporations sometimes repurchase their own shares. When asked why, Target Computers Corp.'s management responded that the shares were undervalued. What advantage would Target Computers Corp. gain by buying and selling its own shares under these circumstances?
3. Target Computers Corp. earned a significant profit in the year ended June 30, 2005, because land that it held was expropriated for a low-rental housing project. The company proposes to treat the sale of land to the government as operating revenue. Why do you think Target Computers Corp. is proposing such treatment? Is this treatment appropriate?
4. The vice-president, finance, of the company wants to disclose a large loss as an extraordinary item because Target Computers Corp. produced too many notebook computers with an older processor. This processor has been made obsolete by a much faster processor that other manufacturers are installing in the notebooks they are producing. Why do you think the vice-president, finance, wants to use that particular disclosure? Would such disclosure be acceptable?

Ethical Issue

Link Back to Chapter 9 (Accounting Principles)

Sapawe Gold Mine Ltd. is a gold mine in Ontario. In February 2005, company geologists discovered a new vein of gold-bearing ore that tripled the company's reserves. Prior to disclosing the new vein to the public, top managers of the company quietly bought most of the outstanding Sapawe Gold Mine Ltd. shares for themselves personally. After the discovery announcement, Sapawe Gold Mine Ltd.'s share price increased from $4 to $60.

Required

1. Did Sapawe Gold Mine Ltd. managers behave ethically? Explain your answer.
2. Identify the accounting principle relevant to this situation. Review Chapter 9 if necessary.
3. Who was helped and who was harmed by management's action?

Problems (Group A)

Problem 14-1A *Journalizing shareholders' equity transactions* ***(Obj. 1, 3)***

HBM Corporation Inc. completed the following selected transactions during 2005:

Feb.	4	Declared a cash dividend on the 30,000 $1.25 preferred shares. Declared a $0.15 per share cash dividend on the 40,000 common shares outstanding. The date of record was February 15, and the payment date was February 18.
	18	Paid the cash dividends.
Apr.	18	Declared a 40 percent stock dividend on the common shares to holders of record on April 29, with distribution set for May 31. The market value of the common shares was $14 per share.
May	31	Issued the stock dividend shares.
June	17	Repurchased 2,800 shares of the company's own common shares at $10 per share; average issue price was $7.50 per share. The shares will be reissued in the future.
Nov.	14	Issued 1,000 repurchased common shares for $9 per share.
Dec.	22	Issued 800 repurchased common shares for $13.50 per share.

Required

Record the transactions in the general journal.

Problem 14-2A *Journalizing dividend and share-repurchase transactions and reporting shareholders' equity* ***(Obj. 1, 2, 3)***


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The balance sheet of Investtech Inc. at December 31, 2005, reported 2,000,000 common shares authorized with 250,000 shares issued at an average price of $2.00 each. Retained Earnings had a balance of $450,000. During 2006, the company completed the following selected transactions:

Feb.	15	Repurchased 20,000 of the company's own common shares at $2.00 per share.
Mar.	8	Sold 8,000 repurchased common shares for $3.25 per share.
Sept.	28	Declared a 15 percent stock dividend on the 238,000 outstanding common shares to holders of record on October 15, with distribution set for October 31. The market value of Investtech Inc. common shares was $3.25 per share.
Oct.	31	Issued the stock dividend shares.
Nov.	5	Consolidated the common shares 1 for 2 (reverse split); one new common share was issued for every two existing shares held. Prior to the split, the corporation had 273,700 shares issued and outstanding.
Dec.	31	Earned net income of $195,000 during the year.

Required

1. Record the transactions in the general journal. Explanations are not required.
2. Prepare the shareholders' equity section of the balance sheet at December 31, 2006.
3. Calculate the average issue price per common share on December 31, 2006.

Problem 14-3A *Repurchasing shares to fight off a takeover of the corporation* ***(Obj. 3)***

Cabotrail Corporation is positioned ideally in its industry. Located in Nova Scotia, Cabotrail Corporation is the only company with a reliable record for its locally managed transport company. The company does a brisk business with local major corporations. Cabotrail Corporation's recent success has made the company a prime target for a takeover. An investment group from Halifax is attempting to buy 51 percent of the company's outstanding shares against the wishes of Cabotrail Corporation's board of directors. Board members are convinced that the Halifax investors would sell off the most desirable pieces of the business and leave little of value.

At the most recent board meeting, several suggestions were advanced to fight

off the hostile takeover bid. The suggestion with the most promise is to purchase and retire a huge quantity of shares. Cabotrail Corporation has the cash to carry out this plan.

Required

1. As a significant shareholder of Cabotrail Corporation, write a memorandum to explain for the board how the repurchase and retirement of shares might make it more difficult for the Halifax group to take over Cabotrail Corporation. Include in your memo a discussion of the effect that repurchasing shares would have on shares outstanding and on the size of the corporation.
2. Suppose Cabotrail Corporation management is successful in fighting off the takeover bid and later issues shares at prices greater than the purchase price. Explain what effect the sale of these shares will have on assets, shareholders' equity, and net income.

Problem 14-4A *Journalizing dividends and stock-repurchase transactions; reporting retained earnings and shareholders' equity* ***(Obj. 1, 3, 6)***

The balance sheet of Marathon International Inc. at December 31, 2004, presented the following shareholders' equity:

Contributed capital	
Common shares, 2,000,000 shares authorized, 500,000 shares issued	$2,500,000
Retained earnings	600,000
Total shareholders' equity	$3,100,000

During 2005, Marathon International Inc. completed the following selected transactions:

Mar.	29	Declared a 20 percent stock dividend on the common shares. The market value of Marathon International Inc. common shares was $4 per share. The record date was April 19, with distribution set for May 19.
May	19	Issued the stock dividend shares.
July	13	Repurchased 30,000 of the company's own common shares at $5 per share; average issue price was $4.83.
Oct.	4	Sold 20,000 common shares for $7.50 per share.
Dec.	27	Declared a $0.15 per share dividend on the common shares outstanding. The date of record was January 17, 2006, and the payment date was January 31, 2006.
	31	Closed the $550,000 net income to Retained Earnings.

Required

1. Record the transactions in the general journal.
2. Prepare the statement of retained earnings at December 31, 2005.
3. Prepare the shareholders' equity section of the balance sheet at December 31, 2005.

Problem 14-5A *Preparing a single-step income statement* ***(Obj. 5)***

The information on the next page was taken from the ledger and other records of Fashion Statement Inc. at September 30, 2005.

Required

Prepare a single-step income statement, including earnings per share, for Fashion Statement Inc. for the fiscal year ended September 30, 2005. Evaluate income for the year ended September 30, 2005, in terms of the outlook for 2006. Assume 2005 was a typical year and that Fashion Statement's managers hoped to earn income from continuing operations equal to 12 percent of net sales.

General expenses	$178,000	Extraordinary gain	$ 50,000
Loss on sale of discontinued segment	27,000	Operating gain, discontinued segment	10,000
Cost of goods sold	705,000	Loss on sale of capital assets	25,000
Income tax expense (saving)		Dividends on preferred shares	20,000
Continuing operations	65,800	Preferred shares, $0.50, 50,000 shares authorized, 25,000 shares issued	375,000
Discontinued segment:		Dividends on common shares	40,000
Operating income	3,500	Sales revenue	1,355,000
Loss on sale	(9,450)	Retained earnings October 1, 2004	296,000
Extraordinary gain	17,500	Selling expenses	200,000
Interest expense	40,000	Common shares, unlimited shares authorized, 40,000 shares issued	800,000
Gain on settlement of lawsuit	25,000		
Sales returns	34,000		
Contributed surplus from retirement of preferred shares	26,000		
Sales discounts	10,000		

Problem 14-6A *Preparing a corrected combined statement of income and retained earnings* ***(Obj. 5, 6)***

MOUNTAIN BIKES LTD.
Income Statement
September 30, 2005

Revenues and gains		
Sales		$1,125,000
Gain on retirement of preferred shares (issued for $60,000; purchased for $45,000)		15,000
Total revenues and gains		1,140,000
Expenses and losses		
Cost of goods sold	$472,500	
Selling expenses	166,000	
General expenses	75,000	
Sales returns	16,500	
Prior-period adjustment—understated income tax for 2004 due to error	7,000	
Dividends	24,000	
Sales discounts	22,500	
Income tax expense	124,775	
Total expenses and losses		908,275
Income from operations		231,725
Other gains and losses		
Extraordinary gain	50,000	
Operating income on discontinued segment	23,500	
Loss on sale of discontinued operations	(40,000)	
Total other gains		33,500
Net income		$ 265,225
Earnings per share		$ 8.84

Thomas Wong, accountant for Mountain Bikes Ltd., was injured in a biking accident. Another employee prepared the income statement, shown above, for the fiscal year ended September 30, 2005.

The individual amounts listed on the income statement are correct. However, some accounts are reported incorrectly, and others do not belong on the income

statement at all. Also, income tax (35 percent) has not been applied to all appropriate figures. Mountain Bikes Ltd. issued 30,000 common shares in 2000 and has not issued or repurchased common shares since that date. The retained earnings balance, as originally reported at September 30, 2004, was $700,000. There were no preferred shares outstanding at September 30, 2005.

Required

Prepare a corrected combined statement of income and retained earnings for fiscal year 2005; include earnings per share. Prepare the income statement portion in single-step format.

Problem 14-7A *Computing earnings per share and reporting a retained earnings restriction* ***(Obj. 4, 5)***

The capital structure of Interior Design Ltd. at December 31, 2005, included 15,000 $2 preferred shares and 380,000 common shares. Common shares outstanding during 2006 were 300,000 in January through March; 316,000 during April; 350,000 May through September; and 380,000 during October through December. Income from continuing operations during 2006 was $810,450. The company discontinued a segment of the business at a gain of $112,270 and also had an extraordinary loss of $93,630. The board of directors of Interior Design Ltd. has restricted $150,000 of retained earnings for expansion of the company's office facilities.

Required

1. Compute Interior Design Ltd.'s earnings per share. Start with income from continuing operations. Income and loss amounts are net of income tax.
2. Show two ways of reporting Interior Design Ltd.'s retained earnings restriction. Retained earnings at December 31, 2005 was $312,800, and total contributed capital at December 31, 2006, is $1,043,330. Interior Design Ltd. declared cash dividends of $450,000 during 2006.

Problem 14-8A *Accounting for stock dividends, stock splits, the repurchase of shares, and the sale of repurchased shares* ***(Obj. 1, 2, 3)***

Kamloops Outfitters Ltd. had the following shareholders' equity on January 1, 2005:

Shareholders' Equity	
Preferred shares, $0.75, cumulative (1 year in arrears), liquidation price of $10, 50,000 shares authorized, 15,000 shares issued and outstanding	$150,000
Common shares, unlimited number of shares authorized, 25,000 shares issued and outstanding	125,000
Total contributed capital	275,000
Retained earnings	225,000
Total shareholders' equity	$500,000

The following transactions took place during 2005:

Jan.	28	Declared a $25,000 cash dividend, payable on March 1 to the shareholders of record on February 15. Indicate the amount payable to each class of shareholder.
Feb.	25	Issued 8,000 common shares for $7 per share.
Mar.	1	Paid the cash dividend declared on January 28.
Apr.	4	Declared a 25 percent stock dividend on the common shares, distributable on May 15 to the shareholders of record on April 15. The market value of the shares was $8.00 per share.

May	15	Distributed the stock dividend declared on April 4.
July	6	Repurchased 10,250 of the company's own common shares at $8.25 per share.
Sept.	3	Issued 5,000 common shares for $8.50 per share.
Nov.	2	Split the common shares 2 for 1.
Dec.	31	Reported net income of $100,000. Closed the income summary account.

Required

1. Record the transactions in the general journal. Explanations are not required.
2. Prepare the shareholders' equity section of the balance sheet at December 31, 2005.

Problem 14-9A *Accounting for stock dividends, stock splits, and prior-period adjustments; preparing a combined statement of income and retained earnings; calculating earnings per share* ***(Obj. 1, 2, 5, 6)***

Val Morin Hardware Ltd. had the following shareholders' equity on January 1, 2005:

Shareholders' Equity	
Preferred shares, $1, convertible to common on a 2 for 1 basis, 50,000 shares authorized, 20,000 shares issued and outstanding	$220,000
Common shares, unlimited number of shares authorized, 50,000 shares issued and outstanding	250,000
Total contributed capital	470,000
Retained earnings	220,000
Total shareholders' equity	$690,000

The following information is available for the year ending December 31, 2005:

Mar.	7	Declared a cash dividend of $50,000, payable on April 1 to the shareholders of record on March 15. Indicate the amount payable to each class of shareholder.
Apr.	1	Paid the cash dividend declared on March 7.
June	6	Declared a 10 percent stock dividend on the common shares, distributable on August 5 to the shareholders of record on July 4. The market value of the shares was $6.25 per share.
Aug.	5	Distributed the common shares dividend declared on June 6.
Sept.	15	Received notification from Canada Revenue Agency that Val Morin Hardware Ltd. had made an error in filing 2003 taxes. The reassessment showed that the company had reported and overpaid $8,000 in taxes.
Dec.	31	Val Morin Hardware Ltd.'s records show the following:

Sales for the year	$850,000
Cost of goods sold	380,000
Operating expenses	255,000
Income from discontinued operations	15,000
Loss on sale of discontinued operations	–10,000
Extraordinary loss	–20,000

Close the income summary account assuming the income taxes on operating income are 35 percent and on discontinued operations and extraordinary items are 25 percent.

Required

1. Record the transactions in the general journal. Explanations are not required.
2. Prepare a combined statement of income and retained earnings for the year ended December 31, 2005. Include earnings-per-share information.

Problems (Group B)

Problem 14-1B *Journalizing shareholders' equity transactions* ***(Obj. 1, 3)***

Assume Conrad Construction Ltd. completed the following selected transactions during the year 2005:

April	19	Declared a cash dividend on the $4.25 preferred shares (1,500 shares outstanding). Declared a $0.50 per share dividend on the 50,000 common shares outstanding. The date of record was May 2, and the payment date was May 25.
May	25	Paid the cash dividends.
June	7	Split the company's 50,000 common shares 2 for 1; one new common share was issued for each old share held.
July	29	Declared a 15 percent stock dividend on the common shares to holders of record on August 22, with distribution set for September 9. The market value was $16 per common share.
Sept.	9	Issued the stock dividend shares.
Oct.	26	Repurchased 5,000 of the company's own common shares at $14 per share. They had an average issue price of $5 per share. The shares were cancelled.
Nov.	8	Sold 1,500 common shares for $19 per share.
Dec.	13	Sold 1,000 common shares for $15 per share.

Required

Record the transactions in the general journal.


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Problem 14-2B *Journalizing dividend and share-repurchase transactions, and reporting shareholders' equity* ***(Obj. 1, 2, 3)***

The balance sheet of Oxalis Ltd. at December 31, 2004, reported 250,000 common shares authorized, with 62,500 shares issued and a Common Shares balance of $400,000. Retained Earnings had a credit balance of $280,000. During 2005, the company completed the following selected transactions:

Mar.	15	Repurchased 9,000 of the company's own common shares at $6.75 per share. These shares will *not* be cancelled.
Apr.	29	Declared a 25 percent stock dividend on the 53,500 outstanding common shares to holders of record on May 2, with distribution set for May 16. The market value of Oxalis Ltd. common shares was $12.50 per share.
May	16	Issued the stock dividend shares.
Oct.	7	Sold 3,000 repurchased common shares for $15 per share.
Dec.	19	Split the common shares 2 for 1 by issuing one new share for each old share held on December 30, 2005.
	31	Earned net income of $244,000 during the year.

Required

1. Record the transactions in the general journal. Explanations are not required.
2. Prepare the shareholders' equity section of the balance sheet at December 31, 2005.
3. Calculate the average issue price per common share on December 31, 2005. Assume no shares were issued or repurchased after December 19, 2005.

Problem 14-3B *Increasing dividends to fight off a takeover of the corporation* ***(Obj. 1)***

U-Track Software Inc. is positioned ideally in the manufacturing and distribution sectors. Located in Brampton, Ontario, U-Track Software Inc. is the only company with a highly developed inventory tracking software. The company does a brisk business with companies such as Home Hardware and Roots. U-Track Software Inc.'s success has made the company a prime target for a takeover. Against the

wishes of U-Track Software Inc.'s board of directors, an investment group from Toronto is attempting to buy 55 percent of U-Track Software Inc.'s outstanding shares. Board members are convinced that the Toronto investors would sell off the most desirable pieces of the business and leave little of value.

At the most recent board meeting, several suggestions were advanced to fight off the hostile takeover bid. One suggestion was to increase the shares outstanding by distributing a 100 percent stock dividend.

Required

As a significant shareholder of U-Track Software Inc., write a short memo to the board advising how a stock dividend would affect the investor group's attempt to take over U-Track Software Inc. Include in your memo a discussion of the effect that the stock dividend would have on assets, liabilities, and total shareholders' equity, that is, the dividend's effect on the size of the corporation.

Problem 14-4B *Journalizing dividend and stock-repurchase transactions; reporting retained earnings and shareholders' equity* ***(Obj. 1, 3, 6)***

The balance sheet of Future Vision Ltd. at December 31, 2004, reported the following shareholders' equity:

Common shares, 200,000 shares authorized, 50,000 shares issued	$1,000,000
Retained earnings	325,000
Total shareholders' equity	$1,325,000

During 2005, Future Vision Ltd. completed the following selected transactions:

Apr.	29	Declared a 12 percent stock dividend on the common shares. The market value of Future Vision Ltd.'s common shares was $18.50 per share. The record date was May 20, with distribution set for June 3.
June	3	Issued the stock dividend shares.
July	29	Repurchased 5,000 of the company's own common shares at $15 per share; average issue price was $19.84.
Nov.	10	Sold 1,000 repurchased common shares for $18 per share.
	25	Declared a $0.50 per share dividend on the common shares outstanding. The date of record was December 16, and the payment date was January 6, 2006.
Dec.	31	Closed the $147,000 credit balance of Income Summary to Retained Earnings.

Required

1. Record the transactions in the general journal.
2. Prepare a statement of retained earnings at December 31, 2005.
3. Prepare the shareholders' equity section of the balance sheet at December 31, 2005.

Problem 14-5B *Preparing a single-step income statement* ***(Obj. 5)***

The information on the next page was taken from the ledger and other records of Strongarm Steelworks Corp. at September 30, 2004.

Required

Prepare a single-step income statement, including earnings per share, for Strongarm Steelworks Corp. for the fiscal year ended September 30, 2004. Evaluate income for the year ended September 30, 2004, in terms of the outlook for 2005. Assume 2004 was a typical year and that Strongarm Steelworks Corp.'s managers hoped to earn income from continuing operations equal to 10 percent of net sales.

Cost of goods sold	$286,000	Preferred shares, $1.25, 15,000 shares authorized	
Loss on sale of capital assets	12,000	7,500 shares issued	$112,500
Sales returns	6,000	Retained earnings, October 1, 2003	55,000
Income tax expense (saving):		Selling expenses	92,500
Continuing operations	31,500	Common shares, 50,000 shares	
Discontinued segment:		authorized and issued	300,000
Operating loss	(3,255)	Sales revenue	570,000
Gain on sale	1,120	Dividends	20,000
Extraordinary loss	(7,000)	Operating loss, discontinued segment	9,300
Gain on sale of discontinued segment	3,200	Loss on insurance settlement	7,000
Interest expense	7,500		
General expenses	76,300		
Interest revenue	3,000		
Extraordinary loss	20,000		

Problem 14-6B *Preparing a corrected combined statement of income and retained earnings* ***(Obj. 5, 6)***

Muriel Thomas, accountant for Art du Monde Ltd., was injured in a hiking accident. Another employee prepared the income statement shown below for the fiscal year ended December 31, 2005.

The individual amounts listed on the income statement are correct. However, some accounts are reported incorrectly, and others do not belong on the income statement at all. Also, income tax (35 percent) has not been applied to all appropriate figures. Art du Monde Ltd. issued 64,000 common shares in 2003 and has not issued or repurchased shares since that time. The retained earnings balance, as originally reported at December 31, 2004, was $485,000.

ART DU MONDE LTD.
Income Statement
2005

Revenue and gains		
Sales		$488,000
Proceeds from sale of repurchased shares		110,000
Gain on retirement of preferred shares (issued for $73,000; repurchased for $57,000)		16,000
Total revenues and gains		614,000
Expenses and losses		
Cost of goods sold	$122,000	
Selling expenses	90,000	
General expenses	97,600	
Sales returns	12,200	
Dividends	8,900	
Sales discounts	8,000	
Income tax expense	20,000	
Total expenses and losses		358,700
Income from operations		255,300
Other gains and losses		
Loss on sale of discontinued operations	$ (4,000)	
Extraordinary flood loss	(25,000)	
Operating loss on discontinued segment	(12,000)	
Prior-period adjustment—understated income tax for 2004 due to an error	(5,000)	
Total other losses		(46,000)
Net income		$209,300
Earnings per share		$ 3.27

Required

Prepare a corrected combined statement of income and retained earnings for 2005; include earnings per share. Prepare the income statement portion in single-step format.

Problem 14-7B *Computing earnings per share and reporting a retained earnings restriction* ***(Obj. 4, 5)***

The capital structure of Motown Marketing Inc. at December 31, 2004, included 50,000 $1.00 preferred shares and 74,000 common shares. The 50,000 preferred shares were issued in 1999. Common shares outstanding during 2005 were 74,000 January through April; 80,000 May through September; and 85,000 October through December. Income from continuing operations during 2005 was $162,700. The company discontinued a segment of the business at a gain (net of tax) of $12,365, and an extraordinary item generated a gain (net of tax) of $61,270. The Motown Marketing Inc. board of directors restricts $165,000 of retained earnings for contingencies.

Required

1. Compute Motown Marketing Inc.'s earnings per share. Start with income from continuing operations. Income of $162,700 is net of income tax.
2. Show two ways of reporting Motown Marketing Inc.'s retained earnings restriction. Retained earnings at December 31, 2004, was $194,250, and total contributed capital at December 31, 2005, is $500,000. The company declared dividends of $66,000 in 2005.

Problem 14-8B *Accounting for stock dividends, stock splits, the repurchase of shares, and the sale of repurchased shares* ***(Obj. 1, 2, 3)***

Atlantis Communication Inc. had the following shareholders' equity on January 1, 2005:

Shareholders' Equity	
Preferred shares, $1.10, cumulative (2 years in arrears), liquidation price of $10, 100,000 shares authorized, 15,000 shares issued and outstanding	$ 75,000
Common shares, unlimited number of shares authorized, 25,000 shares issued and outstanding	62,500
Total contributed capital	137,500
Retained earnings	160,000
Total shareholders' equity	$297,500

The following transactions took place during 2005:

Jan.	14	Declared a $40,000 cash dividend, payable on March 1 to the shareholders of record on February 1. Indicate the amount payable to each class of shareholder.
Feb.	28	Issued 10,000 common shares for $2.50 per share.
Mar.	1	Paid the cash dividend declared on January 14.
Apr.	1	Declared a 30 percent stock dividend on the common shares, distributable on May 2 to the shareholders of record on April 15. The market value of the shares was $2.60 per share.
May	2	Distributed the stock dividend declared on April 1.
July	4	Repurchased 3,000 of the company's own common shares at $2.00 per share.
Sept.	2	Issued 2,500 repurchased common shares for $2.50 per share.
Nov.	2	Split the common shares 2 for 1.
Dec.	31	Reported net income of $102,000. Closed the income summary account.

Required

1. Record the transactions in the general journal. Explanations are not required.
2. Prepare the shareholders' equity section of the balance sheet at December 31, 2005.

Problem 14-9B *Accounting for stock dividends, stock splits, and prior-period adjustments; preparing a combined statement of income and retained earnings; calculating earnings per share* ***(Obj. 1, 2, 5, 6)***

Retread Inc. specializes in truck tire retreading and had the following shareholders' equity on January 1, 2005:

Shareholders' Equity	
Preferred shares, $1.25, convertible to common on a 3 for 1 basis, 100,000 shares authorized, 50,000 shares issued and outstanding	$262,500
Common shares, unlimited number of shares authorized, 100,000 shares issued	250,000
Total contributed capital	512,500
Retained earnings	290,000
Total shareholders' equity	$802,500

The following information is available for the year ending December 31, 2005:

Feb. 1 Declared a cash dividend of $75,000, payable on March 1 to the shareholders of record on February 15. Indicate the amount payable to each class of shareholder.

Mar. 1 Paid the cash dividend declared on February 1.

May 2 Declared a 20 percent stock dividend on the common shares, distributable on July 4 to the shareholders of record on June 15. The market value of the shares was $3.25 per share.

July 4 Distributed the common shares dividend declared on May 2.

Aug. 8 Received notification from Canada Revenue Agency that Retread Inc. had made a mistake filing 2002 taxes. The reassessment showed that the company had reported and underpaid $15,500 in taxes. The amount of taxes unpaid was due on receipt of the reassessment.

Dec. 31 Retread Inc.'s records show the following:

Sales for the year	$525,000
Cost of goods sold	215,000
Operating expenses	132,000
Income from discontinued operations	22,000
Loss on sale of discontinued operations	12,500
Extraordinary loss	20,000

Close the income summary account, assuming the income taxes on operating income are 35 percent and on discontinued operations and extraordinary items are 25 percent.

Required

1. Record the transactions in the general journal. Explanations are not required.
2. Prepare a combined statement of income and retained earnings for the year ended December 31, 2005. Include earnings-per-share information. For purposes of the earnings-per-share calculation, the weighted average number of common shares is 110,000.

Challenge Problems

Problem 14-1C *Explaining the effects of a share repurchase* ***(Obj. 3)***

Assume e.Wat Inc., a public company listed on the TSX Venture Exchange, had issued 20,000 common shares at incorporation at a price of $11.00. The book value per share was $17.00 at the most recent year end. The company has been paying an annual dividend of $0.78 per share.

Recently, when the market price of the shares was $14.00, the company decided to repurchase 3,000 shares at that price.

You and a friend bought 100 shares each when the shares were issued. Your friend wonders whether she should sell her shares back to e.Wat Inc. since the company was offering 27 percent more than she had paid.

Required

Analyze the information provided to help your friend decide whether or not she should sell her shares back to the company.

Problem 14-2C *Income from continuing operations, discontinued operations, and extraordinary items* ***(Obj. 5)***

In the late 1980s, the CICA's Accounting Standards Board set out fairly restrictive rules for disclosure of discontinued operations and extraordinary items. The rules limited management's ability to classify a transaction as relating to discontinued operations or as being an extraordinary item.

Required

Explain why management, in the absence of the rules in the *CICA Handbook* described above, might classify a financial event or transaction as extraordinary versus classifying it as part of continuing operations.

Extending Your Knowledge

Decision Problem

Analyzing cash dividends and stock dividends ***(Obj. 1)***

Fraser Valley Technologies Inc. had the following shareholders' equity on December 31, 2005:

Common shares, 200,000 shares issued and outstanding	$4,000,000
Retained earnings	2,400,000
Total shareholders' equity	$6,400,000

In the past, Fraser Valley Technologies Inc. has paid an annual cash dividend of $4.00 per share. In 2004, despite a large retained earnings balance, the board of directors wished to conserve cash for expansion and did not pay a cash dividend but did distribute a 10 percent stock dividend. During 2005, the company's cash position improved. The board declared and paid a cash dividend of $3.00 per share.

Suppose you own 10,000 Fraser Valley Technologies Inc. common shares, acquired January 2, 2003. The market price was $50 per share before any of the above dividends.

Required

1. How did the stock dividend affect your proportionate ownership in the company? Explain.
2. What amount of cash dividends did you receive in 2003? What amount of cash dividends did you receive in 2005? Would you expect the dividend per share to remain unchanged?
3. Immediately after the stock dividend was distributed, the market value of Fraser Valley Technologies Inc. shares decreased from $50 per share to $45.45 per share. Does this represent a loss to you? Explain.
4. Suppose Fraser Valley Technologies Inc. announces at the time of the stock dividend that the company will continue to pay the annual $4.00 cash dividend per share, even after the stock dividend. Would you expect the market price of the shares to decrease to $45.45 per share as in Requirement 3 above? Explain.

Financial Statement Problem

Retained earnings and earnings per share (Obj. 2, 5)

Use the Intrawest Corporation financial statements in Appendix A to answer the following questions.

1. Intrawest's 2003 financial statements reveal that the company has a contributed surplus at June 30, 2003, that did not exist at June 30, 2002. How much is it and how did it arise?
2. Did the company discontinue any of its operations during the year? Did the company have any extraordinary gains or losses during the year?
3. Did Intrawest have a prior period adjustment during the year?
4. Prepare a T-account for Retained Earnings to show the beginning and ending balances and all activity during the year ended June 30, 2003.
5. Use the information in the financial statements to calculate the weighted average number of common shares outstanding. What is the number of actual shares outstanding at June 30, 2003?



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